In the pre-Southern-Cone-failure literature, trade liberalization was essentially conceived of as the process of replacing quantitative restrictions with moderate import tariffs or export subsidies. The fundamental objective of the reform was deemed to correct the existing protectionist bias in favour of domestic markets. Consequently, the reform of the tariff structure proposed was aimed at ensuring the neutrality of incentives regarding production for exports and for import substitution.

In practice, the process of the restructuring of the tariff structure has proved to be very complex. Writing a few years later, in 1983, Krueger said that experience suggested three important points:

(a) Reduction in protection implemented through quantitative restrictions is feasible - conversely, efforts to replace quantitative restrictions with tariffs provide ample time for political pressure;

(b) Protection of inputs must be removed before protection of output;[8]

(c) For successful trade liberalization it is fundamental that nominal devaluation be consistent with inflation.

On a more abstract level, it can be said that there are two problems which play a central role in designing the stages of trade liberalization. On the one hand, the existence of differential responses of various industries gives rise to complicated questions regarding the timing of the lifting of sectoral trade barriers. On the other, it is crucial to ensure consistency between trade liberalization and current account equilibrium (Michaely, 1986; World Bank, 1987). None of these two questions have been easy to manage in concrete liberalization experiences.

The existence of distinct speeds of adjustment of individual industries generates a policy dilemma (especially in cases such as that of Argentina in the late 1970s, when there was an attempt to shorten dramatically the duration of the trade reform period). The dilemma stems from the fact that while differential responses of industries calls for a discriminatory treatment that precludes uniform treatment of all the activities, discriminatory treatment contradicts a much praised objective of the reform which is to reduce the variance of protection rates so as to induce an increasing and rapid convergence of such rates.

It is often argued that protectionist policies should not be tried on the grounds that Governments do not usually have the knowledge or information needed to pick correctly the winners (Fischer, 1990). This may be true. But the dismantling of protectionism seems to require a lot of information, too. Viable activities could be spoiled if the speed and attributes of the stages of trade reform were poorly designed and/or implemented. Perhaps it is precisely because of this factor that successful liberalizations have taken so long a period. The Southern Cone experience seems to suggest that there are no solid grounds for assuming that the costs of protectionism are greater than those of the failures of the liberalization attempt.

According to the 1987 *WDR*, the more ambitious and long-lasting liberalizations (Spain, Greece, Israel, Chile) all began with macroeconomic stabilization while the countries that tried to liberalize trade in the midst of macroeconomic crises failed. There is absolute agreement with this statement by the authors taking the line of the market-friendly approach. In the context of trade deregulation, macroeconomic policy must assure a balance of payment equilibrium and the stability of a competitive exchange rate prior to the reform. These points will be discussed in more detail below.

B. Domestic financial market deregulation

The problem of speed and attributes of the stages of domestic financial market liberalization is one of the most obscure in the literature. The 1989 *World Development Report* was devoted to analysing experiences of domestic financial liberalization; indeed, the horrors of

[8] The much praised (before collapsing) Argentine attempt at liberalizing trade incurs this error.

financial liberalization described there are at least as discouraging as those which have been documented on the failures of protectionism.[9] Yet, the 1989 *WDR* concludes that despite the mistakes made in reforming the financial system, there was likely to be less waste of resources than if interventionism were maintained. No empirical estimation of such a contention is given. Instead, some lessons are extracted from the study of several reform-induced financial crises (mainly in Latin America, the Philippines, Turkey and even the Republic of Korea) that should be taken into account in designing the stages of financial decontrol:

(a) If the reform is implemented in an unstable macroeconomic environment, the reform *per se* can induce more instability, basically because both the real interest rate and the spread between the lending and the borrowing rates are likely to increase.

(b) If market prices are distorted owing to the existence of controls or a protectionist policy, the liberalization will not help to improve resource allocation: the system would respond with more flexibility to erroneous signals. Correction of the exchange rate, trade liberalization, and privatization should precede financial liberalization.

(c) A clear set of laws and regulations should be substituted for direct intervention in the financial system.

(d) The authorities should anticipate how relative prices will be affected by the reform because some transitory compensation measures may be necessary.

According to the 1989 *WDR*, the non-feasibility of one-step financial liberalization gives rise to complicated questions of timing: if the reform process is too rapid, firms could face heavy losses; if there is an excessive delay, the cost of perpetuating financial inefficiency will be higher.

This seems sensible for the transition period, but many unsettled questions remain on both empirical and theoretical levels. On empirical grounds, the most important problem is what excessive delay means in terms of real time. For example, upon analysing the "optimal" path of financial deregulation for a typical former socialist country, McKinnon (1991) felt that "the authorities should move cautiously, perhaps waiting for *some years* before establishing independent commercial banks that are only indirectly regulated or controlled by the central bank" (page 7). He also says that Japan after 1949 exemplified a poor country embarking on rapid growth while keeping suitable financial constraints in place. But Japan began to liberalize its financial system only recently. This seems to be a long if not excessive delay.

From a theoretical viewpoint, the problem is: if the transitional period is conceived of as taking, say, a decade, and financial deregulation is so vulnerable to policy failures, what are the benefits of financial liberalization? This seems to be a valid question for two reasons. First, if the financial system can only be deregulated after the economy is as mature as Japan's, financial liberalization should surely be considered a indicator rather than an engine for development. Secondly, given the extension of the repressed period before liberalization, how to manage a repressed financial system in order to propel development may be fruitful problem to analyse in terms of the research agenda.

Indeed, the research agenda regarding the problems of transition between repression and liberalization seems to be moving in this direction. McKinnon (1991), for example, has made an effort to analyse better the stages of liberalization. As a result of this analysis, very little of his previous approach to financial liberalization stands. In the seminal works of McKinnon (1973) and Shaw (1973), financial liberalization was conceived of as a means to induce financial deepening and thus increase the availability of credit in the formal financial system. The freeing of interest rates, on the other hand, would not only expand the demand for domestic financial assets but also help to mobilize savings and to improve the allocation of funds available for investment. In this way, financial deepening became a powerful engine for growth by increasing the rate of savings and improving investment productivity.

If the lessons of concrete experiences of liberalizations are taken into account, however, financial liberalization could be an extremely expensive luxury good for unstable countries. For example, according to McKinnon (1991): "Failure to recognize the need for official action to limit bank lending rates was, in part, responsible for the financial collapses in the Southern

9 See chapters five and nine of the 1989 *WDR*.

Cone... To achieve high real financial growth, successful developing economies have combined domestic price stability with substantial, even if regulated, nominal rates of interest on both deposits and loans" (page 91). Likewise, "without price-level stability, unpredictable volatility in real interest rates or exchange rates makes unrestricted domestic borrowing and lending by deposit-taking banks - which must always be regulated to ensure the safety of the payments mechanism - simply too risky" (page 6). Consequently, it is better that "newly liberalized enterprises do *without* credit from the organized banking system. Until financial conditions are stabilized, decentralized firms in industry and agriculture best rely mainly on *self-finance*, on borrowing from nonmonetary financial sources, and by broadening equity participation in the enterprise itself" (page 7). One wonders, however, how equities could be a source of finance in economies where "open markets for common stocks, bonds, mortgages, or even commercial bills are typically insignificant" (page 84).

A direct consequence of these characteristics of the transition period is, then, that "some degree of financial repression" coupled with credit rationing may be warranted. Indeed, in the 1950's, when Taiwan had high and variable inflation that was more or less successfully offset by high and variable nominal interest rates, the commercial banks were state-owned and did not compete much among themselves" (page 41).

In brief, the conclusion on this point is that the research agenda on the role of the financial system in development is open. There are many crucial questions but very few answers beyond those based on casual empiricism.

C. Deregulation of the capital account

As has been shown, the literature emphasizes that controls on capital flows should be maintained until trade liberalization is finished.[10] But there is no detailed analysis of the stages or the speed with which the capital account should be opened up. Indeed, regarding the capital account, there is not much mentioned beyond the warning that, during the transition to a free-market economy, allowing free international capital mobility could lead to unwarranted capital flight or the build-up of foreign indebtedness (McKinnon, 1991). In a certain sense, the literature seems to lag behind the ongoing attempts at liberalization. For example, in the present Latin American context, while decisive steps toward deregulation are being taken, the capacity of the governments to regulate the flow of external capital is practically nil. And, indeed, the present reversal of the capital flight process of the 1980s is generating severe disturbances. Specifically, Argentina, Chile, Colombia, and Mexico are experiencing significant problems in trying to coordinate capital inflows with both the timing of reforms and macroeconomic equilibrium. In such a context, the advice on controlling external flows has no empirical relevance given the *de facto* openness to capital flows in these countries.

D. Deregulation of labour and other domestic goods markets

"Whereas there are questions about the speed of response of the trade sector, the response of the banking sector to deregulation, and so on, there are fewer questions regarding economic behaviour when sectoral markets are concerned. Instead, the difficulties become increasingly political, as income- distributional questions come to the fore. Resistance to reforms of pricing of food, urban transport, energy, and other publicly provided goods and services is encountered largely because of consumer, rather than producer, interest" (Krueger, 1986, page 29). That is, as has been seen before, it is considered that the deregulation of these markets is always welfare improving with the only problem being the resistance of agents whose interests are affected.

[10] Harberger (1986) gives a somewhat different rationale for intervening in the capital market based on the existence of externalities. See also the comments of Dornbusch (1986) on this.

There are good reasons, however, to think that the effects of decontrolling domestic markets should be more carefully analyzed. Three questions should be emphasized in this regard. First, from the demonstration of the second-best theorems, it follows that when there are non-market constraints, the deregulation of an individual market can be expected to be welfare-improving only if the production and utility functions are more or less separable, that is, when the market under analysis has no important linkages with others. But it does not seem to be the case of "some publicly provided goods and services", which in the typical LDC includes, for example, the provision of energy in its various forms. This means that price decontrols can affect not only consumers but also producers.

Secondly, a sharp shift in the cost of energy or a strong change in income distribution (for example, because of fuel or food price decontrolling), will trigger non-negligible *spillover effects* on other markets. As the disequilibrium approach to macroeconomics has shown,[11] spillover effects are of great importance in determining the macroeconomic disequilibrium regime. For example, during the 1980s, some hyperinflationary episodes in Latin America were triggered by attempts at correcting lagging public prices and exchange rates. Likewise, the elimination of food subsidies greatly contributed to further reducing effective demand in the midst of a macroeconomic crisis in such countries as Venezuela or even the former Soviet Union. Is it wise to induce an effect like this on effective demand while domestic industry is going through a restructuring process because of protection reduction? This seems to be a very important problem regarding the sequencing of liberalization, especially in the former socialist countries. Again, it does not seem to be a problem only for consumers.

The last point has to do with privatization. Tariffs are very likely to be raised by a government before selling a public enterprise in order to augment profitability and thus the private and foreign investors' willingness to bid for public enterprises. This happened in Argentina. As a consequence, the prices of some services now provided by the private sector are well beyond international prices. Given that some of the privatized enterprises now enjoy both a monopoly position and natural protection, the level of domestic prices vis-à-vis international prices is not likely to change. It follows that badly implemented privatization could heavily impinge on the competitiveness in industry and other tradable sectors in the economy. This runs against the goals of trade reform. Its effects on international competitiveness are similar to those of reducing protection for final goods while leaving protection for intermediate products unchanged. Neither is this a consumer-only problem.

E. The relationship between liberalization and stabilization

In the discussion of the problems of sequencing, macroeconomic issues are brought into the picture for two basic reasons:

(a) As we have seen, if there are short-run rigidities, there could be short-run output losses;

(b) If the transition is mismanaged - as is supposed was the case of the Southern Cone liberalization efforts - there will be additional costs and disturbances that could cause the reform to break down (Edwards, 1986). Furthermore, according to Edwards, there are strictly political reasons for discouraging a simultaneous attempt at stabilizing and liberalizing: the costs of stabilization and liberalization could be confused.

McKinnon (1991) stresses that "how fiscal, monetary, and foreign exchange policies are sequenced is of crucial importance. Governments cannot, and perhaps should not, undertake all liberalizing measures simultaneously. Instead, there is an "optimal" order of economic liberalization" (page 4). The "optimal" order defined in the literature distinguishes two stages which an economy should go through from stabilization to growth (Selowsky, 1990; Fischer and Husain, 1990).

11 See, for example, Benassy (1982).

During stage I, economic policy should almost completely focus on establishing a sound macroeconomic setting. Achieving a primary fiscal surplus is a priority at this stage. Accordingly, fiscal reform following the Washington Consensus guidelines should be implemented.[12]

In addition to fiscal imbalance, the typical macroeconomic setting of a repressed economy is deemed to include inflation and a misalignment of relative prices (mainly a lagging exchange rate). Consequently, the fiscal reform to be implemented during stage I is appended to the standard IMF stabilization package so as to cope with inflation and incorrect relative prices.

In order to induce a correction in relative prices, devaluation and domestic prices, decontrol is recommended. With regard to inflation, a key role is assigned to keeping the level and the rate of growth of aggregate demand in a sound relationship with the level and growth prospects of the economy's aggregate supply. This means controlling not only the fiscal deficit but also keeping domestic credit expansion in an appropriate balance with the prospective path of desired money holdings (Guitian, 1987; Kahn, *et al.*, 1986).

Stage II comprises the implementation of the set of policies aimed at bringing private incentives more in line with true economic scarcities, that is, the launching of the liberalization package.

The sequencing of stabilization and structural reform in terms of stages I and II is the "official" economic policy recommendation of the Washington Consensus.[13] But, what are the theoretical foundations for this?. In analysing the relationship between liberalization and stabilization, Krueger (1986) asks herself: should total decontrol precede macroeconomic stabilization?. Her answer is: "I have nowhere seen an analysis of this circumstance" (page 29). In other words, as in the case of the "optimal" sequencing of individual markets decontrol, "more research is needed" with regard to the dynamic properties that characterize the micro/macro interactions during the transitional process.

There is a wide consensus on the fact that liberalization without stability is not likely to succeed, particularly because it is necessary to eliminate uncertainty about future key relative prices. Indeed, McKinnon (1991) considers that the most important task of stabilization in preparing the scenario for successful liberalization is that of eliminating the uncertainties referring to future price level, future interest rates and exchange rates. But beyond the desirability of these objectives, there are no clear indications on ways to manage the transition between stages I and II.

Two problems should be emphasized regarding the sequencing of the two stages. The first concerns fiscal adjustment and the second refers to exchange rate policy. Fiscal adjustment affects the "optimal" sequence. A large fiscal deficit requires time to reduce government spending and to raise taxes (Krueger, 1983), and the period of time required does not seem to be short. After ten years of adjustment efforts in Latin America, McKinnon (1991) noted that the economies suffering from the debt crisis "have not been able to put sufficient internal fiscal and monetary controls in place to support a dismantling of their interventionist policies" (page 3). In the former socialist countries, on the other hand, the time period necessary to complete fiscal adjustment will likely be longer since "before direct central government controls are fully dismantled the monetary- financial-fiscal system has to be converted from the *passive* mode that has simply accommodated the planning mechanism into an active constraining influence on the ability of decentralized enterprises, households, and even local governments to bid for scarce resources" (page 3). That is, in such countries, it is not just a matter of tightening the government budget constraint, the adjustment process may include the whole society.

Concern over exchange rate policy may be attributable to the fact that more efforts at liberalizing the trade regime have foundered because a nominal exchange rate was pegged and inflation did not abate, than for all other reasons combined (Krueger, 1983). That is, a lagging exchange rate can cause the whole liberalization effort to collapse.

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12 See Williamson (1990) for the details. The 1988 *World Development Report*, which is devoted to fiscal issues, provides an ample view of the Washington Consensus approach to fiscal policies.

13 See the 1991 *World Development Report*. For a critical evaluation of the *Report* and the Washington Consensus recommendations, see Fanelli, *et al.* (1990 and 1992).

As is well known, there are relevant trade-offs between the objectives to be pursued in defining the exchange rate policy. There are at least three possible criteria for evaluating the suitability of exchange rate regimes: external balance, internal balance, and efficiency (Joshi, 1990). The problems posed by these criteria constitute the core of the difficulties in managing stabilization and structural reform. According to the weight given to each objective, the positions about the "optimal" exchange rate policy will differ. This seems to be the case in regard to the liberalization literature: there is no uniform position on which exchange rate regime would be optimal for the transition period.

According to Krueger (1986), a crawling peg can assure some degree of independence of the two reform efforts. But this position far from represents a consensus. Many authors believe that it is better to keep to a fixed exchange rate as an anchor for nominal prices (Dornbusch, 1990) although Lal (1986) considers that "the adoption of a floating exchange rate could ease the transitional pains of a trade liberalization program" (page 217).

In the light of these contradictions, it seems that the issue of the relationship between stabilization and structural reform is far from settled, as it appears to be in the Washington Consensus policy recommendations.

IV. The Southern Cone experience revisited

As has already been mentioned the so-called Southern Cone experiments in liberalization played an important role in the gestation of the sequencing issue. However, the cases look relevant in themselves simply because there are not very many episodes of drastic liberalizing reforms capable of providing empirical material for evaluation. (Another relevant case for that matter is the Bolivian economy after 1985). The reforms that many countries have implemented recently, or are now implementing, tend to generate institutional and regulatory settings similar to those created by the Southern Cone experiments. Were the crises in which they concluded a matter of sequence, or were there other elements to blame? If these elements could be identified, another source of criteria would be available for policy guidance (other than that of sequencing).

With regard to the evaluation of these past experiences, it is worth stressing that their diagnosis in terms of "correct" or "incorrect" sequencing of reforms has an implicit and strong *a priori* assumption. The implicit assumption is that the attempted reforms, correctly ordered, would have necessarily set the economy on a stable path with a significant rate of growth. This assumption rests on no other foundation than beliefs derived from simplistic models. Moreover, there are no reasons to exclude *a priori* the possibility of explosive paths (i.e. financial crises of the kind experienced by Chile and Argentina) or stagnant equilibria (i.e. the process experienced by Bolivia after the reforms implemented in 1985) independently of the order in which reforms are implemented. Specifically, it is suggested that the instability of the Southern Cone experiments can be analysed focusing on some characteristics of the financial markets which have not been highlighted by the sequencing literature, such as the relative size of national markets vis-à-vis the size of capital flows.

There seems to be a consensus that in both the Argentine and Chilean cases the destabilizing effects of capital flows were the *prima facie* cause of the financial and balance-of-payment crises. The stylised facts of both experiences can be seen in tables 1 and 2.[14]

An injection of external funds financed an initial expansionist phase while the amount of funds intermediated by the financial system and the number of intermediaries grew swiftly. Together with the expansion of consumption and, to a less degree, investment, external funds also financed speculation in domestic real and financial assets. Following the lifting of controls, capital inflows adjusted quickly, much faster than the rise in imports. Hence, in both Argentina and Chile, the central banks accumulated reserves in the first phase. Because the

14 The presentation of the cases is based on Frenkel (1983 a) and Frenkel (1983 b) for Argentina and French-Davis y Arellano (1983). Arellano (1983), Diaz Alejandro (1985) and Corbo (1985) for Chile.

Table 1

ARGENTINA: SELECTED MACROECONOMIC VARIABLES 1977-1983

	1977	*1978*	*1979*	*1980*	*1981*	*1982*	*1983*
GDP growth rate (per cent)	6.3	-3.3	6.5	1.0	-6.4	-5.2	3.3
Inflation rate (CPI)	160.0	169.3	140.1	87.5	131.2	209.7	433.6
Trade account [a]	1490.0	2566.0	1110.0	-2519.0	-287.0	2288.0	3332.0
Current account [a]	1290.0	1834.0	-550.0	-4768.0	-4714.0	-2538.0	-2437.0
Real exchange rate [b]	100.0	79.9	57.4	44.7	57.3	101.6	117.7
M1/GDP	6.6	6.4	6.2	7.6	6.3	4.9	3.8
M2/GDP	13.2	17.6	19.0	24.9	23.6	16.9	11.6
Real borrowing interest rates	-7.2	-15.7	-9.0	-4.4	9.8	-29.8	-29.1
Real lending interest rates	23.1	9.4	3.5	26.7	7.1	-36.1	-19.5
Difference between lending interest rates and preannounced exchange rate variation [c]							
Montly rate			3.1	4.0	5.8 [d]		
Annual rate			43.9	60.7	95.9 [d]		
National savings rate	26.0	22.9	19.7	17.4	12.0	12.4	10.8
Gross fixed investment rate	27.2	24.4	22.7	22.2	18.7	15.5	17.3
Reserve increment [a]	2227.0	1998.0	4443.0	-2796.0	-3807.0	-651.0	244.0
Gross debt increment [a]	1399.0	2818.0	6538.0	8128.0	8509.0	5032.0	4384.0
Net debt increment [a]	-828.0	820.0	2095.0	10924.0	12316.0	5683.0	4140.0

Source: Central Bank of Argentina, National Institute of Statistics and Fundación de Investigaciones Económicas Latinoamericanas.

a In billions of dollars.

b Nominal exchange rate (peso/dollar) deflated by domestic consumer price index.

c From January 1979 to March 1981.

d Annualized rate for the first three months of the year.

preannounced rate of devaluation (the *tablita*) was lower than the actual rate of inflation, and because this rate of exchange rule initially enjoyed a high level of credibility, arbitration between external and domestic assets and external and domestic credit reduced the nominal rates of interest and the expected cost of external credit vis-à-vis the rate of inflation. This price effect operated together with the quantity effect to drive the expansion in the first phase. The flow of imports rose gradually but steadily and the burden of interest earned by the accrued external debt also grew, producing a rising deficit in the current account. At a certain point, the inflow of capital was less than the current account deficit and the level of reserves stopped growing and began to decline, triggering a second phase of the process.

The fragility of the financial system rose *pari passu* with the expansion of assets and liabilities of the financial system in the first phase, because a significant part of credit had financed consumption and speculation with existing assets during the boom. In both the Argentine and Chilean cases, the real rates of interest began to grow at a certain point. In the second phase, the rise in the rates of interest and the roll-over of the pre-existing debt contributed additionally to increase the fragility of the system.

The high real rate of interest which characterized the second phase of the process deserves attention. Microeconomic arguments such as the adverse selection of risk and moral hazard in the banks have been used to explain statically why banks were able to charge such high rates. A less often mentioned point is that real rates of interest fell in the first phase and then showed an upward tendency.

Table 2

CHILE: SELECTED MACROECONOMIC VARIABLES 1977-1983

	1977	*1978*	*1979*	*1980*	*1981*	*1982*	*1983*
GDP growth rate (per cent)	9.9	8.2	8.3	7.8	5.5	-14.1	-0.7
Inflation rate (CPI)	63.5	30.3	38.9	31.2	9.5	20.7	23.1
Trade account [a]	34.0	-486.0	-355.0	-764.0	-2677.0	63.0	986.0
Current account [a]	-551.0	-1088.0	-1189.0	-1971.0	-4733.0	-2304.0	-1117.0
Real exchange rate [b]	100.0	108.9	95.6	83.0	83.4	105.1	125.6
M1/GDP	6.4	6.2	6.2	7.3	5.9	6.5	6.6
M2/GDP	13.0	16.0	17.4	19.3	23.4	24.7	20.0
Real borrowing interest rates	18.7	25.0	4.7	5.0	28.7	24.3	4.0
Real lending interest rates	57.1	42.3	16.9	12.2	38.9	35.1	15.9
Difference between lending interest rates and preannounced exchange rate variation [c]							
Montly rate		3.4	2.9	3.3	3.5	3.5 [d]	
Annual rate		49.6	40.5	46.9	51.9	51.7 [d]	
National savings rate	10.7	12.6	12.4	13.9	8.2	2.1	4.4
Gross fixed investment rate	13.3	14.5	15.6	17.6	19.5	15.0	12.9
Reserve increment [a]	165.0	785.0	1256.0	1760.0	-299.0	-1197.0	-555.0
Gross debt increment [a]	236.0	1413.0	1584.0	1906.0	3140.0	1262.0	1017.0
Net debt increment [a]	71.0	628.0	328.0	146.0	3439.0	2459.0	1572.0

Source: Central Bank of Chile.
a In billions of dollars.
b Nominal exchange rate (peso/dollar) deflated by domestic consumer price index.
c From February 1978 to May 1982.
d Annualized rate for the first five months of the year.

Three factors seem to explain the rising rates of interest in the second phase. First, an exogenous shock: the increase in the international rates which began at the end of 1979. The jump in the international rates contributed to elevating the domestic rates, but of course it cannot fully explain the increment. A disaggregation of the actual domestic rate in that period, as the sum of the international rate, the rate of announced devaluation, and a residual accounting for exchange risk, shows the latter to be the main factor explaining the increase in the domestic rate. Secondly, there was an endogenous effect of the expansion of the system while it evolved to finance riskier operations. Thirdly, the lack of credibility of the announced exchange rule in the face of the results in the external accounts was a factor. Information about the rising current account deficit or the declining level of reserves made prospects for the sustainability of the exchange rule less certain. So, a higher exchange risk premium was needed to equilibrate the demand for domestic and external assets.

By influencing exchange-rate expectations, the deterioration of the current account in the second phase imposed higher rates of interest to sustain the demand for domestic financial assets. However the rise in interest rates made the system more prone to a generalized crisis. This constituted an explosive process. At the end of the process there was no rate of interest high enough to sustain the demand for domestic assets, and both the Argentine and the Chilean experiences ended up in a run against the Central Bank reserves and a generalized bankruptcy.

It has not been stressed, but it is worth mentioning that the effect of the perceived increasing fragility of the domestic financial system also contributed in itself to weakening the

demand for domestic assets, adding to the effect of the information on the external accounts. This is so even in the case of Argentina, where an explicit deposit insurance was in force. The relative weights of the negative prospects of the external accounts and the perceived fragility of the financial system are impossible to unravel. However, the bad news about the domestic system - localized bankruptcies of financial institutions - had been announced well before difficulties in the external accounts became apparent.

The rates of inflation were high when the policies were launched (much higher in Argentina than in Chile) and the programmes were intended not only to deepen and integrate the financial system, with the expected effects on efficiency, savings and investment, but also to perform a stabilizing function. Specifically, policy on the rate of exchange was aimed at reducing the rate of inflation and did not belong to the reform package by internal logical necessity. As the policies actually executed were a specific mix: there is a need to disentangle cause and effect using the best analytical capabilities and common sense. In any case, this is a characteristic feature of any evaluation of concrete historical episodes. These cases are particularly demanding because they involve several drastic policies enacted simultaneously.

It is apparent that the real appreciation explains a significant part of the observed results in both cases. It has worked in two different ways. First, the appreciation had a real effect on relative prices and on the tendency of the trade account. Secondly, the dynamics of gradual appreciation had a financial effect: by lowering the real domestic interest rate and the cost of international finance measured in domestic prices in the first phase, stimulating then consumption and speculation with domestic assets.

Conversely, it seems evident that the high rates of inflation, or rather, its unexpected stubbornness, were the cause of the observed appreciation, giving the rates of devaluation established by the *tablitas*. As a consequence, it should also be evident that the unexpected stickiness of the rates of inflation played an important role and that any explanation of the observed results must account for it.

Before going ahead with the evaluation, it is worth mentioning that some conclusions and policy recommendations can be, and have been, reached at this level of the analysis. The dramatic results observed in the Southern Cone experiences called attention to the risks involved in liberalizing the flows of capital under conditions of high inflation. Particular caution calls for combining free capital flows with the active utilization of the rate of devaluation as a gradual tool for disinflation. Under high rates of inflation, a crawling-peg exchange rate policy and controls intended to inhibit capital flows are recommended. With regard to the working of the domestic financial system, one conclusion is that reforms of the kind attempted in Chile and Argentina can increase its volatility. Elimination of gross distortions are then recommended, but combined with a regulatory setting intended to reduce volatility of real interest rates. It could be said that under conditions of high inflation, stabilization policies should have priority over structural reform attempts. These seem to be sensible recommendations, but can sometimes be rather unrealistic. In many cases of accentuated instability, exemplified by some Latin American economies in the 1980s, the same acceleration of inflation gave place to "parallel" markets which actually curtailed the regulating capability of the State. In such cases, the financial domestic markets and the capital flows adjust more or less "freely", even if regulations are in force.

As has been stressed here, it should be evident that the stickiness of inflation explains a significant part of the results observed in the Southern Cone experiments. The point gives rise to two different questions. First, was the dynamics of appreciation, if not the sole factor, then the main factor explaining the results or do other plausible factors have similar relevance? Secondly, what are the main causes of the stickiness of inflation and, consequently, of the distortion of relative prices produced by the exchange policy? The analysis continues with a discussion of the latter question, leaving the former to be commented on later.

The stickiness of inflation was in no way a new issue, but the impressive result of the drastic experiments with exchange policy called renewed attention to this complex problem. Although several researchers inspired by events focused on the issue to find analytical explanations,[15] this was not the case of the first evaluations of the Southern Cone experiments made by some friendly partners. The first evaluations of the Argentine experience, made while

15 See for example the research results presented in Figueiredo *et al.* (1985).

Chile was still considered to be a sound case, bypassed the explicit consideration of the stickiness of inflation and focused directly on the significant deficit of the public sector, treating it implicitly as the main explanation for the prevalence of high rates of inflation. It has to be said that this was an *a posteriori* remark, because the "monetary approach to the balance of payment" which originally inspired the implemented policies denied the relevance of any sectoral deficit and put all the burden of the stability of the balance of payments on monetary policy. On the other hand, at that time there was a firm belief in the policy relevance of the "law of one price". Thus, the lack of sufficient external trade was thought to be the condition which allowed a persistent difference between the rate of inflation and the rate of devaluation. On the basis of this argument, the lack of enough trade liberalization completed the diagnosis of the Argentine case vis-à-vis the still "well-behaved" Chilean case.

Elimination of fiscal deficit and complete trade liberalization were posed as logical necessary conditions for the success of the financial reform and the freeing of capital flows. Were they sufficient conditions? At the time, the still successful Chilean case was there to give an empirical affirmative answer. The sequencing view of the problem followed from this line of reasoning. In the Argentine case, the necessary conditions had not been fulfilled, and so the financial reform and the liberalization of capital flows were premature measures vis-à-vis the correct order exemplified by Chile.

The Chilean crises (the simultaneous balance-of-payments and financial crises) should have made the whole argument on sequencing unlikely, constructed, as mentioned, on the comparison between Argentina and Chile. Indeed, as was emphasized by McKinnon in 1981, before the crises started, the Chilean reforms looked quite complete at that time. When the *tablita* exchange policy was initiated, the public accounts were in surplus and the trade liberalization was almost complete. The last reduction of tariffs to a uniform 10 per cent level was part of a schedule preannounced well before, and was synchronized in June 1979 with the announcement of a fixed nominal exchange rate. However, instead of suggesting a reconsideration of the sequencing explanation of the Argentine crisis and a reformulation of the whole problem, the Chilean experience also came to be considered an example of mistaken sequencing on the basis of new arguments. Differences in adjustment velocities between goods and financial markets were focused on in criticizing the simultaneous opening of the trade and capital accounts (Edwards (1985)). Conversely, indexation of nominal wages was highlighted as an important factor behind real appreciation (Corbo (1985)) and so, a significant factor of the failure.

The mention of backward-looking indexation of nominal wages (as inconsistent with the forward-looking fixation of the nominal exchange rate) provided an *ad hoc* explanation for the stickiness of inflation in the Chilean conditions of fiscal surplus. Indexation of wages and other nominal contracts had been indicated in the Argentine case as explaining inflation inertia (Frenkel (1983 c, 1984), but these arguments were disregarded in the above-quoted friendly evaluation, probably because fiscal deficit was considered to be a sufficient explanation. More or less formalized indexation rules were indeed in force in both Argentina and Chile. This was not amazing, after an extended period of high inflation, even if fiscal adjustment had been fulfilled.

The argument about different velocities of adjustment of goods and financial markets was aimed at simultaneously explaining the real appreciation and the overborrowing feature. Financial markets are supposed to adjust faster than goods markets. The argument goes as follows. Starting from an economy repressed in both trade and capital flows, the simultaneous opening of goods and capital markets determines a rising tendency of imports and capital inflows. Because capital inflows adjust quickly, there is an excess supply of currency which causes a tendency of the exchange rate to appreciate. The real appreciation gives an additional impetus to imports and trade deficit. The appreciation process continues while capital inflows exceed the current account deficit. The final result is an "overborrowing" situation.

Although the model seems to describe realistically some relevant features of both the Argentine and Chilean experiences, it is weak as a complete explanation of the cases considered. First, the model lacks a transmission mechanism to explain real appreciation. Under fixed exchange rate regimes, it implies that the above- mentioned stickiness of inflation is mainly explained by pressures exerted by the capital inflows. This argument is not very plausible. One, there was inflation before the inflow of capital and it did not accelerate with its entry. On the contrary, rates of inflation slowed down, even though they remained higher

than the rates of devaluation. Two, as stated already, both cases showed strong evidence of indexation of wages and other contracts as the principal factor behind inflation inertia. This raises the question of the causality of the process. If real appreciation is mainly produced by the nominal exchange rate policies lagging behind inertial rates of inflation, causality runs from real appreciation to capital inflows and not in the opposite direction. Then, rephrasing the argument concerning different velocities of adjustment, it could be said that capital inflows adjusting faster than trade made it possible to sustain a lasting process of real appreciation.

Secondly, the model does not account for the simultaneous reserves and domestic financial crises. The atemporal symmetry of neoclassical models suggests a second phase in which the external deficit exerts a pressure for devaluation, reversing the initial appreciation and leading the exchange rate to an equilibrium level. In a fixed exchange rate regime, this would imply nominal deflation of wages and prices, which does not seem plausible.

This explanation dismisses the liquidity difficulties facing by financial intermediaries and agents indebted in domestic and external credit. In fact, the downturn of the initial boom was not a smooth process but rather a combination of bankruptcies and a run against the central bank reserves. The actual processes have been described better by the Minsky model of a financial cycle, in which an initial bubble is followed by financial distress and a final crash.

Beyond its inability to explain fully the Southern Cone episodes, the different-velocities-of-adjustment model stresses an important feature: capital flows can have significant macroeconomic effects. The potential effects of capital flows depend on their relative size vis-à-vis the size of real and financial assets of the domestic economy. The cases under discussion are small economies which opened their capital accounts from a relatively low level of financial intermediation. But this is usually the case of "financially repressed", less-developed economies attempting to reform. Hence, the macroeconomic importance of capital flows seems to be an intrinsic element.

In analysing the Southern Cone experiences, the real appreciation that played a crucial role in these cases has already been emphasized. Keeping in mind the macroeconomic importance of capital flows, appreciation can be put on a secondary plane, while attention is turned to the rapid rise of domestic financial assets and international financial exposure which characterized both the Argentine and Chilean experiences. As can be seen in the tables 1 and 2, M2 as a proportion of nominal GDP in Argentina almost doubled between 1977 and 1980, while at the same time gross external debt rose by about 19 billion dollars. This flow is twice the stock of M2 at the end of 1977. In the Chilean case, M2 as a proportion of GDP was multiplied by two between 1977 and 1981. During this period, the rise in gross external debt was 8 billion dollars, which was about six times the stock of M2 at the end of 1977.

From the point of view of the reformers, this "financial deepening" should be considered (and, in fact, was considered) a successful result of the liberalization. On the other side of the balance sheet, however, the counterpart of the "deepening" was the piling up of consumption credit and speculative assets that did not generate the income flows capable of keeping the system rolling. The willful belief in the beneficial effects of "financial deepening" and the efficiency of free financial markets blinded the reformers to the point of completely ignoring the elements of a speculative bubble pushed by international finance in the expansionist phase. One must not be naive but rather take into account the strong vested interests associated with the rapid expansion of financial intermediation. Nevertheless, the expressed faith in the self-equilibrating character of the process looks striking.

A rising fragility was the counterpart of the rapid expansion of financial assets and international exposure. Was this fragility inherent to the process or could it have been avoided? The long-term sustainability depended on the proportion of real investment capable of producing income and currency which the expansion was financing. A real productivity boom would have been the only way to avoid rising fragility in a context of swift expansion of credit. This was not the case in the Southern Cone experiences.

Initial smallness vis-à-vis international financial markets played a crucial role in the development of the observed financial cycles. But, as has been mentioned above, smallness seems to be an intrinsic characteristic of a less developed economy trying to open up of its financial sector. So, the size and volatility of capital flows will always involve the risk of destabilizing effects of the kind observed in Argentina and Chile.

In what sense can this be interpreted as a matter of sequencing? The policy recommendation from this point of view would say postpone the opening and deregulation until a big, mature and robust domestic financial market had developed. Indeed, this is the position adopted by the founding father of the sequencing issue. Comparing Japan and Taiwan [Province of China] versus Chile and other countries with failed liberalizing experiences, Ronald McKinnon (1991, ch. 3) stresses as exemplary that these Asian countries long maintained controls on capital flows and regulations on interest rates and other aspects of their financial systems, while they were growing and modernizing their economies. McKinnon emphasizes that the M3/GDP relation of Taiwan Province of China amounted to 126 per cent in the early 1980s, when the country implemented some liberalizing measures, and contrasts this degree of maturity with the smallness of Latin American financial markets. The Japanese experience is subject to the same kind of reflection. McKinnon praises the lasting closure of Japan's financial market and observes that the authorities began to think about loosening restrictions on commercial banks only after a substantial deepening had taken place in the nonbank part of the capital market. At that time, the M3/GDP relation of Japan amounted to more than 100 per cent.

"Delaying" the opening and deregulation of the domestic financial market until it has reached complete maturity, as McKinnon proposes on the basis of his analysis of the two cases, seems to be a sensible recommendation. But the maturation process in these cases required about 25 years. To think of this time span as one step in the sequence towards liberalization seems to stretch the sequencing issue too much.

V. Concluding remarks

Many LDCs are now taking decisive steps in the direction of market liberalization. Most of them are former socialist countries or countries which had previously embarked on an import-substitution strategy of development (especially those in Latin American region). *Prima facie*, it may be assumed that these countries have adopted a new strategy of development because they believed that the market-friendly approach was the "optimal" strategy, given the constraints.

Care must be taken when defining the constraints. Particularly, two facts should be kept in mind. First, the States in most of the regions mentioned had been discredited, disarticulated, and were experiencing severe financial problems. Liberalization implied that both the range of activities and the size of the State must be reduced. *A priori*, such a strategy appears to be better fitted to a weak State than a pick-the-winners strategy which implies more state intervention and, consequently, a financially sounder public sector. Secondly, official lenders and other participants of the Washington Consensus are much more inclined to give political and financial support to countries eager to adopt the market-friendly approach. In such a context, the hypothesis cannot be discarded that the adoption of the market-friendly approach in these countries is much more a consequence of the weaknesses of the State than the fruit of strong conviction in free markets. The strategy chosen promises to solve simultaneously two fundamental needs of the State: lack of financing and lack of a clear definition of its role in development.

However, the present authors maintain that these two fundamental problems are not solved, but rather by-passed by the Washington Consensus approach. This is so, among other reasons, because of the problems posed by the sequencing of reforms during the transitional period, regardless of the benefits that could be attained if a free-market situation were reached. In contrast to what may seem obvious at first glance, the long-lasting transitional period of the liberalization strategy of development requires a significant and efficient intervention of the State while the launching of the reform *per se* is unlikely to fulfill the financing needs of the economy. The restructuring experiences of developed economies (Spain, Germany) were both state-intensive and credit-intensive. This was also true for successful LDCs like Chile (after the failure of the liberalization attempt) or the Republic of Korea. Indeed, the lessons on the sequencing of liberalization which appear in the market-friendly approach literature confirm that the problem of sources of funds needed for financing the restructuring and the question of the role of the State in the process are not clear.

From the present analysis of the literature, it follows that:

(a) The transitional period is very long and difficult to manage. Liberalizing trade, the domestic goods markets, the financial system and the capital account will take many years, perhaps more than a decade. During this period, the role of the State is crucial in designing the correct speed and attributes of each stage of liberalization, especially regarding trade, the decontrolling of the capital account, and the financial system.

(b) The transitional period can be very painful and the government must take into account political constraints. Because of the existence of rigidities and frictions, the effects of liberalization coupled with those of stabilization could generate a high unemployment rate and strong income distribution effects. Although, it is assumed that it is better not to implement compensatory policies to offset the effects on income distribution, in fact, the State will have to implement some compensatory policies to make the programme politically feasible.

(c) During the transition period, there will be a reduced availability of credit. Domestically generated credit will be scarce since credit rationing and "some degree" of financial repression are necessary to avoid financial distress. External funds will be rationed because the capital account must be strictly controlled while external support is not likely to be abundant, at least until the completion of stage I (stabilization) when the country will regain credit-worthiness.

(d) The State has a crucial role to play with regard to the regulation of the economy. The analysis of financial crises in the Southern Cone of Latin America, Turkey, the Philippines, *et al.*, shows that the financial system must be tightly supervised by the authorities, including, eventually, credit-rationing and the control of interest rates. The privatization process has not been closely examined with regard to regulation in the typical institutional setting of an LDC; however it follows from the neoclassical framework that the State has a role when non-competitive situations arise from privatization.

This set of important lessons has been extracted from the analysis of numerous processes of liberalization reform which were implemented in the past; the reforms that are now being implemented will surely give rise to several lessons as well. Two examples show the kind of dynamic problems that should be taken into account in analysing the ongoing economic reforms.

First, privatization is typically recommended as a means to improve efficiency. The normally alleged reasons favouring this reform of the State are "microeconomic" and have to do with efficiency and competitiveness. However, most of the countries are privatizing because of "macroeconomic" reasons. Market-friendly reform is perceived as a necessary condition for "eligibility" and thus for restoring creditworthiness. However, the reform package itself has initial costs that cannot be financed until creditworthiness is restored. Consequently, the funds stemming from privatization are being used to finance the sunken costs of the reform. In many cases, this is being done regardless of efficiency (or equity) considerations and in ways that significantly distort market signals. For example, the privatization of public enterprises which produce non-tradable goods exerts a kind of crowding-out effect on investment in tradeable sectors. Moreover, the financing of the fiscal deficit by means of privatization crowds out investment in physical assets, in general. As is well known, privatization as a means of financing the deficit is no different from governments issuing bonds.

Secondly, the literature advises not to lift controls on capital flows. The "real world" situation is that many LDCs cannot exert such controls. The consequence is that the strong destabilizing effects of capital flows cannot be avoided, particularly with regard to exchange-rate volatility and the financial system. For example, in Latin America, the sharp reduction of interest rates abroad (especially in the United States) has determined a reversal of the capital flight phenomenon. As a consequence, after reaching a peak in the 1980s, the real exchange rate began to lag while there was a kind of "financial deepening" based on the increment of short-run deposits. Severe problems in managing monetary policy also arose. Many of the reforms now being implemented are making the situation even less controllable. The funds stemming from abroad which originate in privatizations are inducing an additional downward pressure on the exchange rate. The liberalization of trade has determined a huge

increase in imports; in many countries the trade surplus of the 1980s disappeared; the external debt to GDP ratio is still too high. Because of the lagging exchange rate, a part of the funds that are being repatriated are being channeled towards financing investment in non-tradable goods. In many cases, this problem is aggravated owing to the high return offered by former-public firms which produce services.[16]

Is it best to approach the study of these reforms which many countries are *de facto* implementing by considering them a problem of "sequencing"? The authors believe that this is not the best strategy neither from the view of economic policy nor theory. Instead of beginning from a rather abstract notion of a fully liberalized economic setting, and examining the supposedly correct sequence of steps needed to reach it without difficulties, it would be fruitful to examine the concrete steps of reform and to analyse the specific dynamics they generate. Room should be made for the potential role that government *and* market failures could play in determining the effects of specific measures. As Krugman (1992) put it, "we should keep at least in the back of our minds the thought that is not true that economic theory "proves" that free markets are always best" (page 21).

In addition, the possibility that the dynamic path generated by the reform could be explosive should not be disregarded. The evaluation of the reform experiences in terms of "correct" or "incorrect" sequencing, rests on a strong *a priori* assumption: correctly ordered liberalizing reforms always set the economy on a stable path with a significant rate of growth. This assumption has no foundation other than in beliefs derived from simplistic models. There is no reason to exclude *a priori* the possibility of explosive paths or stagnant equilibria. This is true independently of the order in which reforms are implemented. Such assumptions do not help in understanding the characteristics of real reform processes. It is a fact that many liberalization attempts gave rise to explosive paths which must be accounted for. Obviously, the relevance of this issue is not only analytical.

16 Sourrouille (1992) stresses this effect of privatizations in the Argentine case. On the effects of privatization on capital flows in the case of Mexico see Ross (1992).

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IMF SURVEILLANCE AND THE G-24

C. David Finch

Introduction

The Group of Twenty-Four has long expressed concern that IMF surveillance over industrialized countries is weak. In the last two communiqués it has called for a report from the IMF on that aspect of surveillance.[1] In the absence of a response, this paper has been commissioned. In no sense can it substitute for an IMF report as, with no access to IMF documents, it is not possible to survey recent developments in the surveillance process. Instead the paper sets out the issues raised in the question of the Group of 24, then analyses the prospects as frankly as possible in an attempt to help focus future discussion more practically.

The first section examines the development of the concept of surveillance through the IMF, concentrating on the basic distinction between reviews designed to ensure observance of agreed rules and those intended to facilitate the achievement of shared objectives. The second section attempts to analyse realistically the present prospects for a strengthening of the IMF surveillance process, both for industrialized countries and, more generally, for the entire membership. There is reason to believe that, with time, there would eventually be a strengthening of rules under the IMF. It is suggested parenthetically that the first steps towards greater use of rules might be taken in relation to debt. The discussion then turns to the procedural response, under current rules, which appears inherently the most promising, in the light of present political trends.

This approach leads inevitably to a discussion of a broader range of issues than usual with regard to IMF surveillance. However, trade issues are not discussed here. Wisely the developing countries have undertaken a much more active role in the current round of GATT negotiations. With the outcome still very uncertain, substantive discussion of the remaining issues is not yet possible. Suffice it to say, there are many signs that the leading industrialized countries, unfortunately, lack the political will to act courageously on trade issues in the ways called for if they are to promote the concept of an open global economy underlying the creation of the Bretton Woods institutions.

I. The concept of surveillance

At Bretton Woods the founding fathers of the IMF negotiated a set of rules for the operation of the exchange systems of members. They believed that these rules would provide the basis for averting the economic disasters of the interwar period. The rules featured exchange-rate stability and freedom from exchange restrictions. So as to aid the observance of these rules, they provided, on one side, for financial resources to be made available to ease the economic cost of compliance when conditions turned adverse, and on the other side, for surveillance to be exercised to ensure that there were penalties for any departure, particularly departures from the rules on restrictions.

These provisions were the basis on which IMF surveillance developed. After a tentative first step relying on reports based on discussions in Washington and narrowly focused on ex-

1 "Ministers urged the Fund to prepare a report for presentation to the next meeting of the Group of 24 in 1992 to appraise the surveillance over the macroeconomic policies of the major industrial countries." Bangkok, October 1991. "Ministers...reaffirmed the urgent need to increase the effectiveness of Fund surveillance over macroeconomic and trade policies of the major industrial countries, and urged the Fund to prepare the study requested by the G-24 Ministers...." Washington, April 1992.

change restrictions, it was quickly recognized that visits to capitals were needed and that macroeconomic policies had to be discussed if there was to be an effective role for the IMF in guiding economic policy decisions towards creating the conditions that would permit progress to be made in eliminating restrictions.

These developments transformed IMF surveillance from an exercise in discipline for transgressing countries into an exercise helpful to domestic monetary authorities. In many countries, discussions with IMF staff, who early had become familiar with the experiences of other countries, were found to assist countries in improving their statistics and in focusing the arguments they needed to promote fiscal responsibility and monetary stability. Occasionally the staff statements made at the end of the visits were featured even to the extent of circulation to the cabinet. However, it was the Executive Board discussion, and the consequent decision or summing up sent to the authorities, that provided the central focus. These messages nearly always stressed the issues that the domestic monetary authorities wished to have featured and gave broad support for the actions they deemed needed. Such encouragement, particularly from major industrialized countries, boosted the morale of officials and added weight to Treasury positions in cabinet decisions. The value of this service was openly confirmed when, in the major move to convertibility in 1961, the group of countries dropping their right to temporary restrictions volunteered to continue consultations.[2]

Thus surveillance had a two-fold purpose. One was the original concept of oversight to ensure that policy measures delivered results which conformed to negotiated rules. In addition, a quite distinct concept had evolved of using the consultation process to promote good (meaning "monetary authority-desired") policies. This included, in a broad sense, an intention to encourage coordinated responses to economic problems based on the common values and priorities of monetary authorities. It must be understood that crucial to the political acceptability of this aspect of the consultation process was a conviction that it promoted policies necessary from the viewpoint of direct national self interest. It should also be recorded that considerable support for the consultation process was generated by the value to other countries of the information made available through the staff reports.

When the par value system fell apart and revisions were made to the Articles, this new element sustained continuation of the consultation process. The idea that moral authority could be usefully exercised, even when there were no precise agreed rules, was now applied to exchange rate regimes. The addition of a direct obligation to use the consultation procedures to promote orderly and stable exchange rates gave only a vague legal authority, although it strengthened the already existing moral commitment to pay attention to peer views.

Nevertheless, it must be stressed that the basis for this surveillance was now consent - not obligation to observe rules.[3] The first element of surveillance, the oversight of precise rules, continued only on exchange restrictions, including multiple exchange rates. While their use dwindled, until they survived only in countries in chronic payments problems, in practice the IMF responsibility to encourage the removal of exchange restrictions was exercised through the conditions attached to the use of IMF resources. Consequently, the surveillance process, as implemented by the consultation procedures, became essentially one based on admonition, hopefully bolstered by shared values.

What are these shared values? The core values are rooted in a basic belief in fiscal responsibility and monetary stability in an open market world. They are derived from the universal and unremitting struggles of monetary authorities in all countries against political pressures to spend more than is economically responsible; these pressures stem from the constant struggle to induce special interests to be sufficiently supportive to keep the ruling coalition in power. To this must be added the understanding, strengthened steadily since the creation of the IMF, that an open economy helps in this battle.

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2 In the first volume of the official history of the IMF the process is described in detail with somewhat less emphasis on the staff role. (The International Monetary Fund 1945-1965, Washington, 1969, vol. 1 pp. 472-473 and 477-482.)

3 Jacques J. Polak in his contribution to the Overseas Development Council study "The International Monetary Fund in a Multipolar World: Pulling Together" New Brunswick, Transaction Books, 1989, has given one of the best short descriptions of the developments stressing the value of the consultation reports to other countries (pp. 52-56). While he featured (pp. 59-60) the decentralized (i.e. self interest) nature of the consultation process, obviously affected by his long experience of cooperation to meet evolving problems particularly in the SDR creation, he was then much more optimistic than I was about future IMF influence through peer pressure on policy coordination among the major countries.

There have nevertheless always been additional policies, beyond those based on the core values, which are encouraged during surveillance. On examination, these may be seen to derive principally from changing political conditions. Currently, the collapse of communism has made it possible to target military expenditures as the focus of spending cuts and to expect much broader support for this than was possible previously when security alliances mattered more. Equally, privatization has become a broadly featured element in plans for reform. Other additions to the prescriptions are related more to immediately preceding economic conditions. The destructive deflationary conditions of the 1930s had created a consensus against persistent surplus countries. This led to IMF Articles providing penalties for countries in persistent surplus. Antagonism towards surpluses was not derived from any basic belief or core value of monetary authorities. Thoughout the different conditions of the subsequent decades there was in fact no monetary authority rationale for this attitude. In a world where most monetary authorities faced inflationary pressures and were struggling to achieve an adequate supply of resources for the investments necessary to promote economic growth, a steady external source of finance was always welcome. Such resources could only be provided by other countries showing a persistent current account surplus.

The strength of support for common values was also affected by political realities. Financial agencies needed constant access to more resources, which made them dependent on support from surplus countries.[4] The penalties provided in the Articles for surplus countries, in practice, were dead from the beginning. Yet these provisions undoubtedly had some effect on the principal surplus country - the United States - making it more sensitive to the time necessary for adjustment to succeed in deficit countries.

Of course the concern about surplus countries had also other aspects. In particular, it was rightly considered essential that participation in the IMF meant that any exchange rate depreciation by deficit countries had to be accepted by countries in surplus, as involving appreciation of their currencies. It was also understood that it would be unacceptable for surplus countries to engage in restrictive exchange or trade measures to resist the consequent changes in trade and payments.[5]

This code has been implemented virtually unchallenged. The principal struggle came with the depreciation of the United States dollar in 1971 and in the years immediately following when the distribution of the consequent appreciation was negotiated, at times bitterly, although no one ever raised a direct objection to the code.[6] This achievement is critically important and must not be forgotten when complaints are made about the weakness of IMF surveillance on broader macroeconomic policies where the issues can never be as clear-cut.

What are the consequences of this experience for the concept of IMF surveillance? It must be recognized that the effectiveness of its surveillance over the macroeconomic policies of OECD countries is at present inherently weak. With the lessening of the power of rules on the abandonment of the par value system, it works almost exclusively through the weight it can bring to bear on debates in cabinet. Thus, to be effective, surveillance needs wholehearted allies on the domestic scene. In turn, this reliance is the less secure the further the issues raised in debates move from the core values described above. In addition, its effectiveness depends on policies implemented by the major countries. The inability of the United States administration to deliver the fiscal improvements universally urged by Executive Directors for years in their annual discussion of the IMF consultation report on the United

4 The apparent endorsement in the UNDP "Human Development Report 1992" of a proposal for a 1 per cent penalty - presumably a tax - on the surpluses of surplus countries is a recent example of a proposal that ignores this political reality. Of course an appeal for greater grant assistance by richer countries which carries an implication of higher taxes in these countries is also nearly as unrealistic at present but is socially just and logically inevitable if the world is to progress towards integration.

5 Manuel Guitian in "The Unique Nature of the Responsibilities of the International Monetary Fund" IMF pamphlet series No.46, p. 21, makes this point and stresses that symmetry is not an appropriate description of the objective when the deficit country needs to initiate the action. Guitian in a related study "Rules and Discretion in International Economic Policy" IMF Occasional Paper No. 97, describes surveillance in a broader setting and argues (pp. 10-11) that even when the issue of global adequacy of demand is raised in relation to deficit countries' measures to restrict demand, normally the self-interest of surplus countries can be relied on to give an adequate countervailing expansion.

6 Paul Volcker and Tooyoo Gyohten, in their recent book "Changing Fortunes", New York, Times Books,1992, give a graphic account of the negotiations on the exchange rates of the major countries from 1971 to the present. It features the shift of Japan as the principal surplus country from stubborn resistance to relatively relaxed acceptance of the appreciation of the yen consequent on the depreciation of the US dollar. They also document the declining effectiveness of peer pressure on G-7 macroeconomic policies.

States economy has weakened the force of similar advice given to others. This weakness in peer pressure not only affects the IMF but is also reflected in the steadily declining capacity of the United States authorities themselves to influence the fiscal and monetary policies of their colleagues in the Group of 7.

Consequently, as the Group of 24 has long argued, the most effective vehicle for the support of IMF objectives is the conditionality attached to borrowing from the IMF.[7] Its effectiveness has been strengthened greatly over time by the association of other resources providing IMF financial support. To the extent that the policies promoted are directly related to ensuring the ability of the borrower to repay, this use of conditionality has a firm base. There is all too much evidence of the harm done to borrowers when IMF debt is accumulated without sufficient adjustment, and then must be serviced with priority, not only over other external claims, but even over domestic requirements. To the extent that objectives other than balance-of-payments recovery upset policies promoted by conditionality, the implementation of the values underlying the additional objectives is asymmetrically focused on borrowers.

More importantly, the association by the Paris Club of IMF conditionality with renegotiation of debt terms, combined with a very limited readiness on the part of official creditors ever to reduce the debt adequately to allow a path out from the debt overhang, has forced many countries in Africa with debt problems to submit to perpetual negotiation with the IMF over their economic policies. This exercise in external control is very damaging to the concept of promoting peer values by consent - that is, for other IMF members - now at the centre of surveillance. Effectively, for these debtor countries, it promotes a relationship with the IMF somewhat akin to that of colonial power and colony. Fortunately, there are now some signs of the readiness of creditors to recognize the long-term destructiveness of this approach to the development of independent financial strength in debtor countries. They are beginning to see the need to enable major reductions of the level of debt if debtors are to escape from this system of servitude. Yet, all too often, the creditors ready to act have not been joined by the others; to date there is scant, if any, implementation of official debt reduction on the scale necessary to ensure success.

II. Surveillance prospects

It is of course an impossible task to predict the future of international cooperation, a future so dependent on political events which, as the recent past has shown conclusively, are essentially unpredictable, certainly by an economist. So much will depend on the readiness of the leadership of the major powers to accept and promote the value of an international framework. In 1945, that leadership was forthcoming but current signs are not encouraging. Domestic problems are now overwhelming the political mechanisms of the key major powers to such a degree that the concept of far-sighted cooperation lacks the capacity to attract the attention needed for determined action.

In the longer run, the prospects for IMF surveillance itself depend to an important extent on agreement on new rules. Without some progress towards new rules, the drift towards ever-weakening peer pressure founded on shared values seems inevitable. However, that does not mean that attempts to make improvements should await the negotiation of new rules. Any new rules will certainly stem from a desire to codify practices that have already been widely applied. Any signs of a trend towards a wider application of the practices which the IMF recommends would also give some early strength to IMF surveillance strictures on economic policies.

Realistically this would not seem to be the time to raise questions about new rules. The end of the political division of the world between two deeply antagonistic camps is having

7 From virtually the beginning of their organization, the G-24 have expressed a concern that conditions on lending to deficit countries have produced an asymmetry in the adjustment process. To my taste this was too closely associated with criticism of surpluses. But it was quite correct in its diagnosis that countries borrowing from the IMF were under much more effective pressure to accept IMF values even if the delivery of the desired results was not at all that well assured.

consequences that create overwhelming barriers to initiating new negotiations in the immediate future and this lessens interest of the major country in securing Group of 24 support. The glue binding the old groupings together has loosened, giving way to growing political uncertainties that naturally would inhibit any attempt to reach agreements on new subjects. Even successful completion of the GATT negotiations - crucial for any hope of progress towards sensible world economic arrangements - is in serious doubt.

The new situation of looser world alliances seems to have strengthened a drift towards greater reliance on regional arrangements. European integration leads the way with its intention to move to virtually complete economic integration of a broadening number of countries. Now the United States has begun to develop its own regional grouping, first involving trade with Canada, then involving the Americas more broadly. The negotiations with Mexico on trade have moved ahead and the intention has been expressed to tackle trade negotiations with other countries in the Western Hemisphere as well as doing more to facilitate bilateral debt relief.

Quite apart from the dangers of division based on regionalism replacing global cooperation, the integration of Europe has profound immediate consequences for the IMF. Already it has lessened reliance on the IMF for assistance in the resolution of the payments problems of individual member countries of the European Economic Community (EC). That will become absolute if the Maastricht accords develop as planned and if the consequent integration reduces their original sovereign independence in economic policies to something resembling that of a state in the United States of America. This is already leading to a search by the IMF for new arrangements for formal discussions with the EC in Brussels. It is to be hoped that a system of reports based on direct consultations with the EC will be developed. Their value will of course take time to become established. Meanwhile the role of surveillance in Western Europe can only be expected to be slight.

However, it would be completely wrong to accept the present trends towards more national and regional independence as irreversible. There are fundamental factors operating towards a world system which will eventually dominate. In particular the interdependence of the world is inexorably growing. This concept has been featured in recent meetings on the global environment - a relative newcomer to world negotiations. Such issues, together with the continuing basic political necessity created by nuclear weapons for some world framework for settlement of disputes, can be relied on to help sensitize the public to the need for international rules. On the economic front, while the pervasive need for agreed trade rules will remain the dominant issue, a new element is the increasing evidence that the internationalization of capital markets and corporations has reached the point where stronger international agreements are urgently needed on their supervision, regulation and taxation.

The collapse of communism has specifically strengthened the IMF as an institution with the recognition by the Group of 7 that it should lead their response to the overwhelming need of the new Governments for economic assistance. Following on the lead role given to the IMF in meeting the debt crisis in 1982, this choice underlines the value of an agency that articulates the core values of the major treasuries of the world. When financial resources are needed, the Group of 7 will inevitably press for the support to be given through the IMF because they know it is an agency under their control. This surely causes some qualms among the monetary authorities of the Group of 24 because it opens the possibility that Group of 7 political objectives will intrude into IMF financing decisions, but there is undoubtedly an understanding that this choice provides them with an opportunity to have their views heard on the major world financing actions, in a forum where the core moral values which they share have important weight.

Of course it is not risk-free to the IMF to take on such politically charged roles. In particular, the Soviet collapse, with the dangers of disorder compounded by possession of nuclear arms, surely calls for political support through grants or loans on highly concessional - Marshall Plan type - terms, and not primarily the short- to medium-term funds available through the IMF. The condition for release of financial support is clearly not necessarily the IMF standard of the adoption of policies ensuring early balance-of-payments recovery. In other words, there is an evident danger that the fiscal problems of the leading powers will be allowed to distort the lending decisions of the IMF and undermine its moral integrity by making it obvious that political not economic objectives control IMF actions.

Ultimately, revival of IMF surveillance with any real strength will depend on the IMF regaining a role within the major OECD countries. In the author's view, the circumstances in which that could happen are virtually certain to arise, but the timing is not predictable and it could still be a long way off. Nor is it possible to predict the cause of the tension which would lead to a need for an international response: past crises have had widely varied origins. One sign of weakness which could lead to a useful IMF role is apparent, however. In a growing number of OECD countries, fiscal weakness is leading to a rate of increase in government debt that is clearly unsustainable. In the past, when par values had to be defended, such situations usually led to a balance-of-payments crisis which gave the public a clear signal of a need for action. Now for OECD countries with access to capital markets which are so open and lacking in attention to fiscal discipline - these imbalances seem capable of continuing almost indefinitely. However, as developing countries such as Brazil can testify, delay without remedial action does not mean that reality will not eventually catch up with you - even for countries considered too big to fail.

The United States budget deficit is one of those problems that seemingly is becoming so intractable that only a crisis will produce the political conditions needed for taking definitive action. If this is so, then when the crisis occurs, an evidently strongly supported IMF would be invaluable to the world - and to the other Group of 7 countries - as the most effective, perhaps even the only, way of limiting the cumulation of crisis damage. That would be particularly clear if the triggering event was the emergence of a dollar overhang caused by developments such as those foreseen in the Maastricht accords. The creation of a common currency and central bank for most of the EEC region would sharply reduce the need for dollar reserves as trade within the area would no longer involve foreign exchange. Negotiations on the disposal of the balances released could well be protracted. Any signs of discord could quickly provoke serious market reactions.

The United States is of course not the only candidate for dangerous contingencies. If instead of smooth progress towards integration in Europe, the process were checked decisively by the political forces set in motion by the Danisn rejection of Maastricht, tensions could develop quickly. In particular, Italy would be vulnerable. While Italy has proved that fiscal weakness does not inevitably lead to an early crisis - it is much further along the unsustainable path of fiscal weakness than the United States is - there are growing signs that the end cannot be delayed much longer. That end is still felt to be manageable within an emerging integrated Europe. Should that hope disappear, however, markets could quickly create a crisis. In the predicated disarray within the EEC, it is quite likely that the major developed countries would decide that an IMF role would be again as helpful as in 1976.

These views are not widely held now, in part because the passage of time without a problem has nurtured a belief that open capital markets combined with exchange rate flexibility have superseded the role of official support in major foreign exchange markets. Unfortunately, that belief is not well-founded, as was shown very early in the new system when, in 1976, the United Kingdom was forced by market reactions to seek official help.[8] In crisis situations, markets need to be reassured about the direction of policies. Only official agencies can provide that reassurance by promoting adequate policy actions secured through effective prior negotiation. Not even the IMF could calm markets if its reputation were weakened too decisively by a history of failures, demonstrating a too clear political use of its resources. At present, it could easily fulfil the task for which it was created, namely to help establish order among the major industrialized countries.

Of course a definitive IMF role with the major industrialized countries could be achieved by a change in the rules on exchange rates. There are now clear signs that eventually some return to a reformed par value system will be sought. The growth of adherence to the EMS system shows recognition of the value of such rules to ensure discipline on macroeconomic policies made politically effective by public commitments. Such commitments have been directly rewarded in the market by lower long-term interest rates. There is growing acceptance of the evidence that the rate of growth of the world economy has suffered with the ending of

8 The recently published book about this period in the UK by Kathleen Burk and Sir Alec Cairncross "Goodbye, Great Britain: the 1976 IMF crisis" New Haven: Yale University Press 1992, features the problem faced by the UK Government in convincing the market of the adequacy of the actions until the IMF support was sought. As a participant in those events I differ somewhat from the authors faith that the Cabinet would have acted adequately without IMF involvement.

the par value system.[9] The Group of 5 countries themselves recognized the problem of the lack of a system when in 1985 the Plaza Accords announced limited coordination of exchange rate policies.

However effective exchange rate coordination has been outside the EMS it is still very limited and will remain so within the major industrialized countries until the United States' public has been converted to a different attitude regarding dollar stability. Until a public commitment with clear political consequences can be envisioned in the United States, official views in the major industrialized countries in favour of coherence will not carry conviction that the fiscal and monetary actions necessary for exchange rate stability will, in fact, be given political priority. Consequently, it is premature to raise this issue of new exchange rate rules. Nevertheless, it is right to record that this step is the one which would do the most to achieve the objective of the Group of 24 to create the most favourable world environment for their growth. It now seems likely that eventually this will happen.

While the recovery of surveillance in the sense desired by the Group of 24 countries is crucially dependent on the IMF retaining a role of dealing with its crises in the major industrialized countries, such a role is not the only possible use of IMF surveillance. A more modest but still very important role for surveillance could be created, relating primarily to capital movements to developing countries. The debt crisis of the 1980s has severely limited some capital flows to many of these countries and left new costs through changed bank regulation rules in creditor countries. The flow rate could recover faster, and the costs be reduced, if the framework for future lend was clear. In fact, *ad hoc* debt negotiations have already gone some way towards determining certain elements of a new framework. In particular, short-term commercial debt is almost never subject to loss. However, this assurance is not sufficiently felt for weaker countries to find such credits readily available to them on normal terms.

At some stage, with the help of IMF surveillance, it should be possible to reverse this unfortunate situation. Many developing countries pay a risk premium for short-term trade finance despite the fact that most of them always repay promptly. If developing countries agreed to accept a formal commitment to meet all payments on such debt and to have the IMF monitor compliance in the annual consultations, capital markets would have to respond by lowered charges just as formal EMS commitments have lowered interest rates for the countries just joining. Over time, as the effectiveness of the IMF surveillance became established and bank regulators were induced to change the rules on provisioning, the terms for most Group of 24 countries for such capital from lenders including the commercial banks, would follow a trend back towards normal levels.

This evolution would undoubtedly be resisted by some creditors fearing that it could weaken their bargaining position in disputes over the terms on renegotiated medium-term debt. Their power to coerce the debtor by withholding short-term credit could become ineffective if replacements were available from new lenders who felt secure on account of the new rules. Hopefully the interest of all lenders in order would allow the change to occur. The process might be hastened by the fact that it would be virtually an implementation of the original and unamended intention of the IMF Articles. Payments on "normal short term banking and credit facilities" were defined as current transactions precisely to achieve this outcome. The consultation process, the forerunner of surveillance, focused heavily on any evidence of payments' arrears creating departures from observance of this obligation.

In view of subsequent developments since the last amendment to the Articles, when some debt of sovereign countries was reduced, it must also be understood that such action would be the first step towards creating an IMF-controlled bankruptcy regime for sovereign countries. Now that the objective of preventing all sovereign losses has been so decisively lost, it is time to give thought to codifying the practices that have evolved over the past 10 years. This is necessary if world capital markets are to be allowed to move towards a system in which risks are more specifically identified, permitting the increased costs through higher charges to be limited to those capital flows which it is agreed may be subject to renegotiation,

9 Paul Volcker's question in "Changing Fortunes" (*op. cit.*, p. 291) as to whether "the distinctly poor economic performance of the world generally since the early 1970s - slower growth, deeper imbalances, and greater inflation - is related to the breakdown of the Bretton Woods system" has sparked a renewed interest in the issue. It may well mark an important turning point towards official reexamination of the need for political commitment to exchange rate stability although little will come of it until the voting public has much more striking evidence of crisis.

while charges for other flows - protected from default by IMF rules that have proven their effectiveness - trend towards standard rates.

Readiness to raise this topic would also give the Group of 24 additional strength in pressing for arrangements which could put an end to perpetual debt negotiations and the associated forced IMF negotiations. The moral basis of an international system of peer pressure through IMF surveillance will always be severely compromised in any system which forces a major group of treasuries into protracted and therefore ultimately antagonistic negotiations. There must be a realistic way found for those countries that are still over-indebted through past weakness to recover their autonomy, as private debtors do through bankruptcy laws.

III. Procedures

Clearly the picture painted here of surveillance does not suggest any early breakthroughs. Meanwhile, what changes in IMF surveillance procedures should the Group of 24 be encouraging? In the author's view, the influence of the Group of 24 through the IMF can grow only if it successfully recognizes the need of treasuries everywhere for support. Of course the Group of 24 must be free to urge IMF policy changes, even those which are distasteful to Group of 7 treasuries. Nevertheless, in pressing the IMF to adopt new policies on surveillance, it must be borne in mind that, in practice, the recommendations on macroeconomic policies, in consultations with individual OECD countries, will be limited to those which their treasuries regard as being in the best interest of their countries. This has long been understood by most Group of 24 officials, as the Group was created to produce more monetary-authority-oriented recommendations than had come from the preceding Group of 77.

Of course IMF surveillance, as broadly understood, is not exercised exclusively through annual consultations. For the major industrialized countries, IMF views on their policies are expressed in the *World Economic Outlook*. And in the outlook discussions, Group of 24 spokesmen are most likely to express views divergent from those of the Group of 7. Borrowing countries, like a borrowing sector of a national economy such as farming, are systematically likely to press for weaker monetary policy than the creditors will support. Inevitably this will continue. The equally inevitable general ineffectiveness of this pressure must not lead to despair over IMF surveillance, however. The high moral ground that policies affecting all countries should be subject to review by an authority with universal representation must be guarded. That will help the IMF to retain effectiveness for the time when evolving conditions create a need in industrialized countries for the moral support for internationally appropriate policies which only the IMF can give.

To preserve the greatest opportunity for the IMF - and hence the Group of 24 - to have influence, it is important first that the regularity of consultations be featured and nurtured. Without routine annual discussions, contacts lessen and the scope for influence narrows. Secondly, it is essential, for the spirit of cooperation to prevail, that this process be kept confidential, with any limited exceptions being strictly under local monetary authority control. Fostering public debate against the desires of the Government pushes the IMF dangerously and inappropriately into a political process. Thirdly, the discussions of the IMF Executive Board must remain the focus; discussion should be guided by its possible value at the national level. In this connection, it is most unfortunate if political alliances are allowed to colour significantly the comments made within the Executive Board. Hence, concern about the sustainability of the fiscal position of an ally should not be suppressed in the Board discussions, as seems to have happened on recent occasions with European Community members, and may even have influenced some Group of 24 directors in discussions of the policies of their close associates. The focus must be clearly technical and never guided by political alliance considerations if the Board is to be consistently persuasive.

In principle, paying attention to the level at which consultations take place could be constructive. Expectations that there will always be a meeting of the staff mission with the Ministers of Finance, or that, for certain major countries, the Managing Director will talk to the Minister about the outcome of the Executive Board meeting on the consultation report.

are useful proposals to that end. They can of course only be actively pressed in situations where they are likely to be welcomed, not pushed on unwilling partners.

It would also be appropriate to urge more effective discussions of the macroeconomic policies of the industrialized countries at Interim Committee meetings, where IMF policies are set. However, in substance, the real need in the six monthly set of meetings is to integrate the deliberations of the G-7 more effectively into the IMF as an institution. In principle, the IMF needs a closer association with the G-7 such as was achieved with the G-10. It is regrettable that, in the G-7 meetings, the IMF's role seems to be effectively limited, under present procedures, to a briefing on the *World Economic Outlook*, with the Managing Director in routine attendence only during the background factual discussions. These G-7 meetings have all too often appeared to determine the essence of decisions on IMF policies formally adopted immediately after by the IMF Interim Committee. This openly reduces other ministers of finance to the role of a rubber stamp.

It would seem doubtful if at present effective remedies can be found. This is a time of flux. Efforts for closer ties would surely prove ineffective. If European integration proceeds as planned, a G-3 might replace the present grouping and offer a new chance for reform, perhaps in connection with a consequent renegotiation of the present General Arrangements to Borrow and the associated G-10 role. Whatever the changes, it will be critical, particularly for the G-24 countries, to preserve the role of the Executive Board or, better, strengthen it. It is in Board deliberations, rather than ministerial meetings, that the vital interests of countries can best be defended because there is time to examine the logical and indeed moral basis of any actions and thus blunt the use of naked political power.

IV. Conclusions

The Group of 24 posed a very important question when it asked in effect how does the IMF influence major country macroeconomic policies? The answer is quite unfortunately clear and has been for some time. The IMF presently has a very limited impact and little is achieved by pretending otherwise. That is not the end of the issue, however. Although the immediate future is not promising, and may even involve some further decline owing to growing nationalism, the time will come when the major countries once again come to recognize their need for an IMF-type mechanism. The task is, therefore, to preserve the foothold now existing. That will not be done by premature pressure, particularly any pressure which allies the Group of 24 with attitudes antagonistic to traditional treasury beliefs. That seems to be understood. In the last communiqué, the expression of support for greater fiscal discipline in the OECD countries, to increase the supply of savings from the present desperately low levels, was particularly wise.

In addition, the Group of 24 would be wise to consider the advisability of supporting the establishment of new rules on some types of debt. These would increase the formal role of IMF surveillance to the benefit of borrowing countries, albeit at the expense of their accepting greater formal discipline, a discipline scarcely greater than that which is presently exercised through other procedures. The effect might well be to speed the evolution of more effective debt-reduction plans that could put an end to the indefinite continuation of IMF tutelage of the weaker debtors.

Improved debt arrangements are no substitute for a greater IMF role with major industrialized countries. Nevertheless, such arrangements could help to ensure that when time runs out on a major country, there will be no doubt about the agency used to assist in resolving the ensuring problems. And that will mark the successful achievement of the basic objective of universality raised repeatedly by the Group of 24.

ON FINANCIAL OPENNESS IN DEVELOPING COUNTRIES

Yilmaz Akyüz

Introduction

Recent years have witnessed the increased integration of developing countries into the international financial system. A number of factors have played a major role. Finance has become increasingly internationalized almost everywhere, helped also greatly by rapid advances in communication technology. Moreover, the debt crisis has made the financial markets of many debtor developing countries a major focus of attention by creating new profit opportunities through swaps and other mechanisms. Above all, a major shift occurred towards liberal policies in many developing countries in response to their deep and prolonged crisis. Most of these countries have also liberalized imports, and increasingly relied on exports for growth. However, the degree of internationalization of finance has gone much further than trade; indeed in many countries in Latin America and elsewhere the share of foreign exchange assets and transactions in the financial system is far greater than the share of trade in GDP.

The consequences of financial openness in developing countries have not been adequately treated in the literature on finance and development primarily because this is a very recent phenomenon. The mainstream thinking is largely an extrapolation of "open economy macroeconomics" to developing countries, and treats the issue of external financial liberalization in the context of "sequencing of economic reforms". This literature emerged in large part from an *ex post* attempt to explain why the Southern Cone liberalization experiment failed (Corbo, de Melo and Tybout 1986; Corbo and de Melo 1987; Diaz-Alejandro 1985; Dornbusch 1983; Frenkel 1983; McKinnon 1982). Its implicit assumption is that external financial liberalization is desirable on efficiency grounds; it has positive effects on the level and allocation of investment, and these efficiency gains more than compensate for the loss of macroeconomic policy autonomy.

According to this view, external financial liberalization may give rise to perverse results only if there are distortions and imbalances elsewhere in the economy- e.g. budget deficits, monetary instability, impediments to the proper operation of the pricing mechanism in the markets for goods (such as trade barriers or price controls) or for labour (such as minimum wage legislation or other legal and institutional impediments to hiring and firing). On the other hand, it is argued that since it is not possible to correct all imbalances and remove all distortions at once, external financial liberalization would need to be properly sequenced. Although it is sometimes argued (e.g. Krueger 1984) that it may be difficult to control inflation without liberalizing the economy, the majority view is that domestic financial markets and the current account should be liberalized before the capital account in order to avoid the adverse effects of capital flows on trade and macroeconomic stability, and that fiscal balance and monetary stability should be attained before any liberalization (Dornbusch 1983; Edwards 1984, 1987, 1989; Fischer and Reisen 1992; Frenkel 1983; McKinnon 1982).

There can be little doubt that considerable insight has been gained from the sequencing literature on the macroeconomics of external financial liberalization in developing countries. However, in our view, this approach suffers from major shortcomings stemming from its underlying assumptions regarding the nature of finance and financial markets; namely, finance is primarily about savings and investment, and financial markets are efficient.

These assumptions are not valid. In modern financial markets, finance tends to have a life of its own independent of investment, production and consumption, and there are widespread market failures. This has two consequences which the orthodox thinking overlooks. First, financial openness tends to create *systemic* problems at the macroeconomic level regardless of the order in which various markets are liberalized and distortions removed. Second, financial openness can undermine growth and competitiveness of a developing country by increasing instability, risk and the cost of capital, and by narrowing the scope for

using finance as part of industrial policy. Loss of autonomy in using finance for industrialization is as serious as loss of autonomy in macroeconomic policy, and, again, regardless of the order of liberalization.

This paper aims at discussing these two issues. The next two sections briefly examine the concept and degree of financial openness in developing countries and the nature of international capital flows. The paper then goes on to examine the causes and effects of capital flows, drawing on the recent experience of a number of Latin American countries which received large inflows of capital. This is followed by a discussion of the effects of financial openness on investment and competitiveness, and on the scope for using finance for industrial policy.

I. The extent of financial openness in developing countries

By external financial liberalization we mean policy actions that increase the degree of financial openness, i.e. the ease with which residents can acquire assets and liabilities denominated in foreign currencies and non-residents can operate in national financial markets (including the enjoyment of market access by foreign banks). This definition is wider than liberalization of capital-account transactions between residents and non-residents, since it includes financial transactions among residents denominated in foreign currencies. Such transactions are an important part of finance and banking, and have international characteristics that affect the national economy in ways similar to conventional cross-border financial transactions (Bryant 1987, chapter 3).

In developing countries, the real degree of financial openness does not always correspond to the restrictiveness of regulations ostensibly in force. For one thing, these are not always fully implemented. For another, because financial institutions are underdeveloped, many financial transactions take place in informal, curb markets, which makes it relatively easy to circumvent regulations. Furthermore, a number of specific factors (such as high earnings from tourism and workers' remittances, the presence of transnational corporations, and physical proximity to hard-currency areas) can facilitate the access to foreign currency and financial transfers abroad through informal channels. Liberal treatment of financial inflows abroad, particularly in neighbouring countries, can also impede a country from limiting its degree of financial openness. For instance, in the late 1980s in Uruguay, where banks were free to accept forex deposits and banking secrecy prevailed, about one-half of such deposits were estimated to have belonged to Argentine nationals. Similarly, during the same years tax exemption of foreign depositors in the United States (together with the tax deductibility of interest payments in Mexico) gave Mexican enterprises an incentive to shift their funds to the United States and recycle them back as loans to themselves, thereby avoiding taxes on interest income received while deducting interest payments from their taxable income.

Nevertheless, official policies and a resolve and capacity to implement rules and regulations play the most important role in determining the degree of financial openness. It is therefore not surprising to find a close inverse correlation between capital flight and the degree of restriction on external capital transactions. For instance, in 1988 the total liabilities of banks in the United States to non-bank foreigners amounted to about $90 million (roughly equal to some estimates of capital flight from Latin America during 1977-1983), with the residents of countries such as Argentina, and especially Mexico, holding greater amounts than the residents of countries where capital controls were much tighter (e.g. Brazil). Similarly, the experience of the Southern Cone countries amply demonstrates how liberal treatment of capital inflows and private external borrowing can result in a massive build up of debt abroad.

Three broad types of external financial liberalization may be distinguished. First, allowing residents, especially firms, to borrow freely in international financial markets (and non-residents to invest and lend freely in domestic markets). Second, allowing residents to transfer capital and to hold financial assets abroad (and non-residents to issue liabilities and to borrow in domestic financial markets). Third, allowing debtor-creditor transactions among residents to be made in foreign currencies such as bank deposits and lending in foreign currencies (which often accompanies freedom to buy and sell foreign currency).

These three types of liberalization have not been undertaken in the same sequence. The first wave of external liberalization in developing countries generally took the form of allowing the private sector to borrow abroad. The Southern Cone experience is the best known, and was set in a broad programme of liberalization. However, external borrowing by residents was liberalized also in a number of countries where domestic financial markets continued to be highly regulated (e.g. Turkey in the 1970s, Yugoslavia, and the Philippines). Resident banks were often involved as intermediaries between international capital markets and domestic borrowers. In countries with a sizeable flow of workers' remittances, a particular form of such borrowing took place on a large scale, namely foreign currency deposits offering attractive terms and carrying government guarantees. In almost all these episodes there was a massive build-up of foreign exchange liabilities by private corporations which contributed significantly to the subsequent debt crisis and payments difficulties (Diaz-Alejandro 1985; Rodrik 1986; UNCTAD 1991, Part Two, chapter III).

Although a number of developing countries have adopted capital account convertibility - some to an extent not found in most industrialized countries - most still maintain many restrictions on transferring capital and holding financial assets abroad. However, there has been a tendency to permit and encourage residents to hold foreign exchange deposits with banks at home, both in countries where such deposits were originally permitted for migrant workers and in others with an acute foreign exchange shortage. Many countries have also permitted exporters to retain part of their export receipts and deposit them in special accounts, using them for imports free of any foreign exchange restrictions. The interest rates offered on such deposits are usually above world levels; deposits are highly liquid; even sight deposits earn considerable interest; and they are much more easily accessible than their counterparts in most industrial countries, where minimum limits and/or charges and commissions are applied.

The effect of introducing foreign currency deposits is generally to increase the importance of foreign currency in the domestic monetary system, i.e. encourage currency substitution and dollarization of the economy. In many developing countries where such deposits were introduced, there was not just a once-and-for-all shift from holding foreign banknotes; rather, foreign exchange deposits kept growing, often rapidly, even coming to exceed domestic currency deposits. The share of foreign exchange accounts in total deposits in recent years exceeded domestic currency deposits in a number of developing countries in Latin America as well as in Asia (e.g. Philippines), the Middle East and Europe (e.g. Turkey and Yugoslavia). Even in London the share of total bank claims (including inter-bank claims) on residents in foreign currencies barely exceeds 20 per cent (Bryant 1987, chapter 3; Akyüz 1992b). Moreover, some developing countries have started issuing dollar-denominated or dollar-indexed paper in domestic markets, and even quoted certain public sector goods prices in dollars. In short, the degree of financial openness of many developing countries is much greater than indicated by the degree of capital account convertibility.

Regarding the entry of non-residents to domestic markets in developing countries, recent years have witnessed two major developments: opening capital markets to non-residents and increased access of foreign banks. The debt crisis has increased the internationalization of finance. In many highly-indebted countries, especially in Latin America, the "market-based menu" has generated new prospects for international arbitrage, speculation and windfall profits for a handful of operators in creditor and debtor countries. Various debt conversion facilities have significantly raised the amount of equities and domestic-currency debt assets held by non-residents in such countries. Residents have also been allowed to buy foreign currency in the curb market to purchase debt in the secondary markets; some countries have also encouraged them to do so through tax and other forms of amnesty in order to bring back flight capital. The size of such operations increased so rapidly compared to the monetary base that Central Banks found it very difficult to sterilize their impact; thus, occasionally governments had to limit, discourage or suspend such operations in Argentina, Brazil, Chile and Mexico (UNCTAD 1989, pp. 105-107).

More recently, access of non-residents to national equity markets has been encouraged in the context of privatization programmes. While one of the stated objectives of privatization has been precisely to develop capital markets, increased access to such markets has been granted to non-residents in order to boost demand. Some of the newly-emerging capital markets have come to depend on foreign portfolio investment which often accounts for a major part of capital inflows.

Finally, recent deregulation of domestic financial markets in developing countries has often been accompanied by relaxing restrictions on the entry of foreign banks. However, some major industrialized countries, notably the United States and the United Kingdom, have been advocating further liberalization of trade in banking services in the context of an agreement in the current multilateral trade negotiations. This is largely a reflection of their belief that banks in these countries have a competitive edge compared to their counterparts in developing and other developed countries. The control that banks and other financial institutions can exert over the pattern and scale of production may be thought to help them to regain, at least partly, competitiveness in industry vis-à-vis Japan and Germany; it also explains why the United States and the United Kingdom have been putting pressure on these countries for greater financial openness.

While a fuller treatment of this issue goes beyond the scope of the present paper (see Cornford 1990; and UNCTAD 1990, pp. 137-162 for such a treatment), it is important to note the implications of such an agreement for financial openness in developing countries. Since the competitive edge of foreign banks in developing countries is primarily in transactions with international characteristics, rather than in intermediation in domestic markets (i.e. accepting deposits and extending credits in domestic currency), such an agreement can create considerable pressures for even greater financial openness in developing countries, and interfere not only with policies regarding trade in banking services, but also with the foreign exchange regime and capital controls.

II. Nature of international capital flows

Financial openness has significant effects on domestic asset prices, interest rates and exchange rates because it increases the substitutability of domestic and external funds for resident borrowers, and between domestic and foreign currency assets for lenders. The mobility of capital can make it very difficult to delink the rates of return on domestic financial assets from those prevailing abroad and to decouple interest and exchange rates. Capital flows exert a considerable influence on exchange rates and financial asset prices, and are themselves influenced by expectations regarding rates of return on financial assets denominated in different currencies. This means not only that domestic policies have a new channel of influence on exchange rates, trade, balance of payments and, hence, the level of economic activity (namely, through their effects on capital flows), but also that these will all be influenced by financial policy abroad and by events at home and abroad that alter expectations. This effect of openness is known as loss of policy autonomy; i.e. reduced ability of governments to achieve national objectives by using the policy instruments at their disposal (Bryant 1980, chapter 12).

There is a widespread belief that external financial liberalization in developing countries will give rise to capital inflows provided that it comes after domestic capital markets have been liberalized. It is assumed that because of greater shortage of capital in developing countries, internal financial liberalization will raise interest rates above world levels, and a subsequent liberalization of the capital account will trigger a capital inflow. This is seen as a one-off phenomenon of adjustment of domestic asset prices and interest rates to world levels as capital scarcity is reduced through an increase in the underlying capital flows. This view is based on the assumption that the internationalization of finance allows savings to be pooled and allocated globally through movement of capital across countries in response to opportunities for real investment, thereby improving the allocation of resources internationally and equalizing rates of return on investment everywhere.

However, the evidence strongly suggests that most capital movements are motivated primarily by the prospect of short-term capital gains or losses, rather than by real investment opportunities and considerations of long-term risk and return. Comparison of rates of return on capital investment among the seven major industrial countries shows that, on average, inter-country differences (as measured by the coefficient of variation) in rates of return on capital in the business sector during the 1980s have been as large as they were during the 1960s and early 1970s, when capital was much less mobile among such countries (OECD 1989,

table 53; 1991, table 58). There can be little doubt that inter-country differences in rates of return are partly due to country-specific factors such as tax treatment of earnings on capital assets and depreciation allowances. However, there is no evidence that such differences have widened in more recent years.

In assessing the impact of increased capital mobility on rates of return on financial assets, it is necessary to distiguish between assets denominated in the same currency, but issued in different locations, and those denominated in different currencies. Lowering national barriers to financial flows has no doubt reduced substantially the degree of segmentation of national markets and international dispersion of prices for financial assets with identical default risk and term to maturity, and denominated in the same currency but issued in different countries (e.g. dollar CDs issued by London and New York banks). However, this is not true for assets denominated in different currencies (e.g. United States treasury bills in dollars and British treasury bills in sterling). Convergence of rates of return on such assets implies a tendency for interest rate differentials to equal the expected change in the exchange rate of the currencies in which they are denominated; i.e. the currency offering a higher rate of interest is expected to depreciate against the other currency, over the same time interval as the maturity of the assets. In efficient markets, these expectations should be reflected by forward exchange rates; i.e. the so-called "uncovered interest parity" should hold (allowing for differential risk premium). However, the evidence shows that this has not been the case, particularly in the 1980s, either for the dollar vis-à-vis other reserve currencies, or among the major European currencies (UNCTAD 1987; Akyüz 1992b).

Under these conditions there is no reason to expect real interest rates to be equalized across countries. For this to happen exhange rate changes would not only have to be fully covered by interest rate differentials, but also would have to move with purchasing power parities. The evidence from the major OECD countries shows that these conditions are not fulfilled (Kasman and Pigott 1988; McCauley and Zimmer 1989).

The evidence does not, of course, mean that financial markets are not integrated or that capital is not mobile. Rather, it suggests that international capital movements are not motivated by long-term investment opportunities, and financial markets are not efficient. The speculative element in the prospective return from financial assets is not only dominant but also highly variable, capable of generating gyrations in exchange rates and financial asset prices by causing sudden reversals in capital flows for reasons unrelated to the underlying fundamentals, as the experience of the last decade amply demonstrates. This predominance of speculation over enterprise in the sphere of international finance is not very different from the operation of modern capital markets that Keynes described in chapter 12 of *The General Theory* with metaphors such as "the game of Snap, of Old Maid, of Musical Chairs", and "newspaper competitions", "beauty contests" and "casino games".

III. Capital flows to developing countries

The exposure to short-term, speculative capital flows is much greater for developing than for developed countries. On the one hand, their instability provides greater opportunities for quick, windfall profits on short-term capital movements. On the other hand, the ability of these countries to influence capital flows through monetary policy is much more limited. In a financially open developing country destabilizing capital inflows can always occur regardless of the order in which the markets are liberalized, and how much fiscal imbalance or policy-induced distortion in the exchange rate is present. Such booms do not always end with a soft landing in large part because of bandwagon-type, pro-cyclical behaviour that characterizes international lending and capital flows; a recently liberalized, well-performing economy can suddenly find favour with foreign capital of all sorts, but if things go wrong for some reason, the capital disappears just as rapidly.

While internal financial liberalization strengthens the link between inflation and interest rates, external financial liberalization (unlike trade liberalization) weakens the link between inflation and the exchange rate, causing the latter to be dominated by capital flows instead

of trade balances and the relative purchasing power of currencies; i.e. inflation differentials are more readily reflected in nominal interest rate differentials than in the movement of the nominal exchange rate. Thus, although short-term capital inflows motivated by the lure of quick, windfall profits are often associated with positive *real* interest rate differentials in favour of the recipient, such a differential is not always necessary or sufficient. Capital inflows usually occur when there are nominal interest rate differentials that markets do not expect to be matched by a nominal exchange rate depreciation. Such differentials often emerge when domestic inflation is much higher than abroad and domestic financial markets have been liberalized. Since in many developing countries inflation rates close to those prevailing in the major OECD countries are very difficult to attain, the scope for big arbitrage opportunities to emerge is much greater. Similarly, an expectation that equity prices will rise faster than domestic currency depreciation can prompt an inflow of capital. Both types of expectation can be self-fulfilling since the inflow of funds, if large enough, can itself maintain the value of the currency and boost equity prices.

Such inflows are typically initially a response to a favourable shift in market sentiment regarding the recipient country. This shift may result from external causes such as a sudden rise in export prices, or from internal ones such as reduced inflation, better growth prospects, and greater political stability and confidence in the government's policies and its resolve and capacity to maintain a financially open economy. After the initial shift in market sentiment, bandwagon-type behaviour often develops and creates a speculative bubble where people are lending or investing simply because everybody else is doing the same. When the bubble bursts and the currency comes under pressure, even a very large positive real interest rate differential may be unable to check the capital outflow.

As it is well known, these conditions were broadly fulfilled during the liberalization episodes in the Southern Cone countries in Latin America in the 1970s, when high domestic interest rates, overvalued exchange rates, freedom to borrow abroad and plentiful international liquidity combined to induce capital inflows. There are strong signs that a similar process is under way in a number of Latin American countries today, even though these countries are now in quite different positions compared to the 1970s, as well as differing among themselves with respect to inflation, fiscal posture, and exchange rate and trade policies. It is estimated that the region as a whole received about $40 billion in 1991, three times the level of 1990, the main recipients being Mexico ($16.1 billion), Brazil ($11.6 billion), Argentina ($5.1 billion), Venezuela ($4.8 billion) and Chile ($1.6 billion). In the majority of these countries capital inflows have continued at an accelerated pace in the early months of 1992.

To judge the nature of external capital inflows it is important to know both how the capital is being raised abroad and how it is being used in the recipient country. It is usually the latter aspect that determines its degree of volatility. FDI or enterprise borrowing abroad for investment in productive capacity is generally less susceptible to reversal than inflows directed at the equity market or acquired for relending in the domestic money market or depositing in domestic financial institutions.

While not the whole of the recent capital inflow into Latin America has been for short-term uses, much of it does appear to have been for this purpose. Of the total estimated inflow of $40 billion in 1991, FDI accounted for only about one-third, and if receipts from privatization are excluded the proportion is about one-quarter. Medium- and long-term bank lending was less than 6 per cent of the total; the rest was raised through bond issues, commercial paper and other short-term money market instruments, much of it being used for relending in domestic capital markets, equity investment or refinancing. There were significant differences among countries in the shares of different types of capital inflow. In Chile about two-thirds consisted of FDI, and in Mexico one-third. By contrast, for Brazil about three-quarters seems to have been short-term (Griffith-Jones *et al.* 1992, tables 4 and 5). Thus, there appears to be a close correlation between the distribution of various types of capital flows and fundamentals.

Chile was the first country in Latin America to receive large short-term capital inflows and to experience in consequence real currency appreciation despite no evident "sequencing errors". As noted by ECLAC, the "substantial rise in interest rates ... and the stability of the (nominal) exchange rate encouraged a large increase in the inflow of short-term capital. This, together with the substantial inflow of direct foreign investment, made it more difficult to manage the monetary situation..." (ECLAC 1990, p. 39). Indeed, between mid-1989 and

mid-1990 the average annual rate of interest on short-term loans was about 40 per cent, the consumer price inflation was around 25 per cent while the nominal exchange rate of the dollar against the peso rose by 10 per cent, giving an arbitrage profit at a rate of about 17 per cent on dollars borrowed in the United States market at an interest rate of 10 per cent and lent in Chile in pesos. Export growth fell during the course of 1990, while imports and foreign exchange reserves rose considerably. The interest rate and inflation rate did not change very much between mid-1990 and mid-1991, but the rate of currency appreciation fell. This was because "the monetary authorities adopted a cautious approach based on the assumption that the oversupply of foreign exchange was only temporary and was due to the unusually high price of copper and the low international interest rates" ECLAC (1991, p. 41), and thus tried to slow the capital inflow and the appreciation of the currency through various measures designed to increase the demand for the dollar and to reduce the arbitrage margin. These measures seem to have had some success, since in 1991 the capital inflow declined moderately (by $0.3 billion), whereas in most other countries of the region such inflows accelerated.

In Argentina, where capital inflows are partly connected with privatization, the dollar/peso rate remained virtually unchanged between March 1991 and March 1992 owing to the government's policy of stabilizing it as part of efforts to bring down inflation. Domestic interest rates were around 16 per cent, i.e. two-and-a half times dollar rates, giving a considerable margin for arbitrage. This period was marked by oversupply of foreign currency, a booming stock market where prices increased more than 300 per cent in 1991, a dramatic rise in imports (encouraged partly by trade reform), and a drop in exports.

In Mexico average interest rates (average cost of procuring funds and Treasury certificate rates) were above 30 per cent in 1990, and above 20 per cent in 1991, whereas the currency depreciated in nominal terms by only about 10 per cent in the former year and even less in the latter. Capital inflows played a major role in the boom in the stock market, where the index more than doubled during 1991, foreigners being estimated in the second quarter of 1992 to be holding equities worth more than $25 billion, or about a quarter of the market's capitalization (*Latin American Economy and Business*, May 1992, p.4). One consequence of the capital inflows and currency appreciation has been sharp increases in reserves, as well as in imports and the trade deficit. Although "the capital account surplus in Mexico over the last two years" is believed to be "a result of very favourable expectations for the economy's future, ... some capital flows have been a source of concern for the authorities", who did not rule out "the possibility of temporary short-term outflows", and thus tried to slow such flows through various measures, including the widening of the differential between intervention points for the peso-US dollar exchange rate to allow larger fluctuations and create greater exchange rate uncertainty (Banco de Mexico 1992, p. 144).

In Brazil inflows began to increase sharply at the beginning of 1992, amounting to about $8 billion during the first quarter (of which about $2 billion was for investment in the stock market). There has also been considerable borrowing abroad by exporters and other companies for relending or refinancing, and some accumulation of non-residents' foreign exchange deposits in special accounts. In nominal terms the cruzeiro has been depreciating in 1992 by almost as much as inflation, about 22 per cent per month. Early in the year, for the first time for many years, the rate for the dollar was lower in the parallel than in the official market. Due to a very tight monetary policy, monthly interest rates were around 30 per cent (or 5-6 per cent in real terms), giving a net arbitrage profit of 17 per cent over the first three months. The rise in prices on the stock exchange was even greater; Sao Paulo stock prices doubled in dollar terms from December 1991 to April 1992. Large purchases of foreign exchange raised central bank reserves to $13.7 billion in March 1992, up from $7.5 billion in the same month of 1991 (IESP, June 1992). The Central Bank has been issuing domestic debt in order to sterilize the effects of its dollar purchases on the money supply. Since reserves can earn no more than 5-6 per cent per annum in international markets, while domestic debt carries as much as that *per month*, the operation is extremely costly. On the assumption of a constant real exchange rate and 3 per cent real interest rates per month on domestic debt, the cost of carrying an extra $5 billion of reserves can be estimated to be of the order of $2 billion per annum.

In attempting to evaluate how far such capital inflows can be sustained it is necessary first to distinguish that part which is of a one-off nature. This includes repatriated flight capital and capital attracted by privatization. The latter has been important in Argentina and Venezuela (over one-quarter and three-quarters of their total inflows in 1991, respectively).

Repatriated flight capital is difficult to estimate but seems to be particularly important in Mexico and Chile. With regard to the rest of the capital inflow, it should be noted that the particular configuration of interest rates, exchange rates and stock prices currently prevailing in many Latin American countries, and which attracts short-term capital flows, cannot be expected to last. When the configuration changes, these flows could be suddenly reversed, thus setting off a cumulative process which might extend to all kinds of capital flows, including those unrelated to considerations of short-term gain.

That short-term capital flows can easily be reversed is evident from the experience of Turkey following the liberalization of its capital account and lifting of restrictions on private borrowing in August 1989, although financial capital flows were much more moderate in comparison with Latin America. The domestic lending rate on non-preferential loans was more than 70 per cent throughout 1990, while nominal depreciation of the currency against the dollar was less than 30 per cent, providing considerable incentives for arbitrage. The currency appreciated, although massive increases in imports, particularly of consumption goods (encouraged also by trade liberalization), absorbed most of the capital inflow; the rest was reflected in a surge in the level of reserves, matched by an unprecedented trade deficit and debt accumulation. The net short-term inflow reached $3 billion in 1990 compared to a net outflow of $2.3 billion in the year before. The shift towards the Turkish lira also played a role in a sharp increase in the Istanbul Stock Exchange index, which rose by more than five times in one year. However, the process was reversed in early 1991 with the outbreak of the Gulf War and political uncertainty at home, and the shift to foreign currency has continued after these ended. During 1991 the currency depreciated against the dollar by more than 70 per cent even though inflation was only moderately higher than in the previous year; stock prices fell by one-half from their peak; foreign exchange reserves declined considerably; and short-term capital flows were reversed, registering a $3 billion net outflow in 1991. What is remarkable about this process is that the real domestic interest rates were barely different between the two phases; the major difference was in the state of confidence and expectations, and in the direction of capital flows and in the exchange rate.

The ideal response to increases in such capital inflows is a corresponding increase in domestic investment in traded goods sectors. Imported capital goods can absorb a large part of the capital inflow, thereby preventing a sharp appreciation of the currency. Moreover, they can enhance productivity growth and increase exports, both of which are needed to restore competitiveness impaired by currency appreciation and to raise debt-servicing capacity. But higher investment is not always possible when domestic interest rates are prohibitive, and long-term investment with funds borrowed abroad at lower rates carries considerable exchange rate risk. In such circumstances it is usually much more attractive to buy and sell existing assets than invest. The dilemma is that the high interest rates and/or currency appreciation that attract capital from abroad can also deter investment on which growth and sustainability of capital flows depend.

In most Latin American countries today the real lending rate is in double-digit figures and exchange rate uncertainties are widespread, which make it difficult to restore vigorous growth based on private investment. The public sector, on the other hand, lacks either the resources or the willingness to invest. It is not yet possible to determine the extent to which these capital flows have been translated into higher investment in Latin America over the last couple of years. Although there seems to have been a considerable increase in capital goods imports in some countries, encouraged partly by tariff reductions, the increase in investment in the region appears significantly smaller than the sharp swing in the transfer of resources abroad, which amounted to about 4 per cent of the region's GDP. Indeed, Brazil, which has been receiving large capital inflows, is in a deep recession and the rate of investment seems to have fallen below 16 per cent of GDP for the first time for many years. Similarly, Argentina does not appear to have been able to raise its investment ratio above 10 per cent, or well below levels attained during the late 1980s when the country was making net transfers abroad.

A foreign exchange glut generated by unsustainable capital flows can damage industry through currency appreciation, particularly when it is accompanied by tariff reductions. Concerns on this score are widespread in Latin America, one prominent industrialist being recently quoted as saying that there was a danger that the remainder of Argentina's industrial base would be wrecked because goods were being imported at prices which domestic industry could not possibly meet (*Latin American Economy and Business*, May 1992, p. 6). The dilemma is that if currency appreciation is prolonged, it leads eventually to an external

payments crisis; but if it is suddenly reversed, the arbitrage margin disappears, possibly triggering a sharp reversal in short-term capital flows.

To prevent currency appreciation when there is a massive inflow of capital is no easy task, particularly when it consists neither of FDI nor of borrowing by domestic entrepreneurs for investment and capital goods imports. Increased imports of consumer goods through trade liberalization can prevent a sharp appreciation of the currency. Recently Chile has deliberately used tariff reductions in order to raise the demand for imports and the dollar (ECLAC 1991, p. 41). However, such a strategy adds to foreign exchange liabilities without adding to export capacity - something that was often stressed during the 1980s as the major cause of the debt crisis.

When monetary expansion and currency appreciation are prevented by the accumulation of reserves and the issue of domestic debt, as in the Brazilian case discussed above, the burden falls on the public sector. Fiscal problems can be avoided only if the currency depreciates sufficiently to raise the real domestic currency value of reserves to a level at which the real capital gain on them offsets excess interest payments on domestic debt (i.e. payments arising from the difference between domestic and foreign rates in dollar terms). However, the real depreciation required may have to be very large - more than 35 per cent, for example, in the case of Brazil. Expectations of such a sharp depreciation can easily trigger a large capital outflow. Besides, since the government makes a net transfer abroad to service its external debt, the depreciation increases the real domestic currency value of interest payments abroad. If reserves are used to pay debt, this could mean that the government was borrowing at about 30-40 per cent per annum in real terms to pay its external debt.

There is, thus, no easy way out of the dilemmas caused by speculative capital inflows triggered by very high interest rates and bandwagon-type movements. A number of techniques have been used in order to slow them down. These include reserve requirements (sometimes non-interest-bearing ones) for liabilities of banks denominated in foreign currencies (Chile, Mexico and Turkey); compulsory liquidity requirements on the short-term forex liabilities of commercial banks (Mexico); minimum holding periods (Chile); extension of the fiscal stamp tax to foreign credits (Chile); restrictions on company borrowing abroad through stock and bond issues (Brazil); and limits on the dollar amounts that banks can raise in deposits abroad as a proportion of their total deposits (Mexico). However, such measures have generally had only limited success. Governments are often very shy in applying effective controls for fear of fending off genuine, long-term capital and investment. This is certainly a legitimate concern, particularly in Latin America, after a decade-long foreign exchange strangulation. However, experience shows that effective capital controls might have to be introduced anyway if the process develops into a payments crisis and capital flight. It may be easier to restrict short-term inflows and prevent debt accumulation early on than to check capital flight in a crisis.

Instability in short-term capital flows combined with the inherent volatility of capital held in stocks and shares exposes the economy to even greater risks when a close link develops between capital and currency markets. Since opening up domestic capital markets requires some form of currency convertibility for non-resident equity investors, such a link can develop even in countries where the capital account is not fully open. This may present a serious problem in Latin America because of the increased presence of non-residents in capital markets. The link is also strengthened because the residents of many countries of the region often have easy access to foreign currency assets.

This link increases the potential for the emergence of foreign exchange and/or stock market crises. Since the return on investment to the foreign investor depends largely on the movement of the exchange rate, a serious shock (e.g. a terms of trade deterioration) that makes a devaluation appear inevitable can trigger both a sharp decline in equity prices and an outflow of capital. Similarly, the mood in equity markets can exert a strong influence on the exchange rate - e.g. bullish expectations can trigger capital inflow, leading to overvaluation. By contrast, a more bearish mood in the capital market and/or massive profit-taking in dollars by non-residents can not only prick the speculative bubble in the stock market, but also lead to a currency crisis. This is a particularly acute danger when the currency is allowed to continue to appreciate and short-term flows are encouraged to enter the capital market unchecked. Evidence from recent years suggests that strong destabilizing influences between financial and currency markets can easily develop; for instance, when the bubble burst in the

Tokyo stock exchange at the beginning of 1990, there was a massive shift out of yen-denominated assets, causing also considerable drops in the government bond index and the currency (Akyüz 1992b).

In order to curb such destabilizing feedbacks between currency and capital markets various restrictions may be introduced in developing countries. One common measure is to limit foreign ownership to approved country funds and allow transactions on such funds only among non-residents in order to control the flow of foreign funds in and out of the country via capital markets. This can be combined with the requirement that such funds be managed by local managers who are generally more amenable to "moral suasion" by the authorities. It should be noted, however, that if such restrictions prove effective, they will tend to discourage capital inflow. In several industrialized countries capital markets have been opened up to non-residents only very recently. In Japan, for instance, they were largely closed until the 1984 agreement with the United States, and even in Europe, where an integrated financial market is seen as an important step in the completion of a single EEC market, restrictions on entry into capital markets still remain in a number of countries (e.g. France and Italy). Again, Korea only recently opened up its capital market to non-residents (apparently in order to help lift the prices after a massive drop), but restricted foreign acquisition to 10 per cent of total equity capital (i.e. less than one half of the level in Mexico mentioned above), and to 2 per cent in some strategic industries.

IV. Risk, cost of finance, investment and competitiveness

Integration of a developing country into an international financial system characterized by volatile capital flows tends to generate *systemic* influences that can undermine its growth and competitiveness. These effects occur primarily through two channels: risk and the cost of capital. Sharp swings in the direction of capital flows, and instability of exchange rates and interest rates associated with them, tend to increase risk, liquidity preference, and the interest rate, thereby reducing investment. The high cost of capital also creates a serious competitive disadvantage for industry in world markets, and competitiveness cannot always be restored through adjustments in exchange rates because they are governed by capital flows rather than trade.

The Keynesian notions and analysis of the borrower's risk and the lender's risk as determinants of investment and interest rate provide an appropriate framework for discussion of the effects of financial liberalization on risk and the cost of capital (Akyüz 1992a). The "entrepreneur's or borrower's risk ... arises out of doubts in his own mind as to the probability of his actually earning the prospective yield for which he hopes.... (I)t is a real social cost, though susceptible to diminution by ... an increased accuracy of foresight" (Keynes 1936, p. 144). Thus, while the borrower's risk is inherent in all investment decisions, its level depends, among other things, on the access of the borrower to reliable information and the stability of economic conditions. The expected rate of return on investment must be high enough to cover both the borrower's risk and the cost of finance.

An important determinant of the rate of interest is the lender's risk. It arises in a number of ways. First, the risk due to the possibility of involuntary default by the borrower; in other words, in a system of borrowing and lending, the borrower's risk is at least partly duplicated in the interest rate. Second, voluntary default, or what Keynes calls the moral risk; the lender must make allowance for the dishonesty of the borrower and non-enforcement of contracts. Third, the lender also runs a risk regarding the capital value of his assets, due to uncertainties over future interest rates, asset prices and the price level.

External financial liberalization in a developing economy can increase both the borrower's and the lender's risks; i.e. it can raise the rate of return required by both investors and savers. Thus, contrary to the orthodox view, financial openness in developing countries can raise the cost of capital and depress investment.

The borrower's risk tends to increase because of instability of exchange rates. For investors in traded goods sectors, the real exchange rate (measured in terms of wages and prices

of non-tradeable inputs) is the single most important relative price affecting profits. Firms operating in non-traded goods sectors are also affected by the exchange rate, depending on the imported inputs they use. In both sectors, large swings in exchange rates result in considerable uncertainty regarding prospective yields of investment. This will raise the average rate of return required by investors to undertake investment, particularly in the traded goods sectors, and depress the level of investment to be undertaken at any given rate of interest.

The importance of the exchange rate as a variable influencing investment decisions increases with the share of foreign trade in the economy. It is thus of growing importance in the developing world because of widespread import liberalization and greater dependence on exports for growth. But simultaneously the exchange rate is becoming a variable pertaining to the sphere of finance, determined largely by capital flows delinked from trade and investment. Large swings in exchange rates can thus undermine the success of the new "outward oriented" strategy by depressing investment in traded goods sectors. The evidence suggests that such adverse effects have occurred even in industrial countries, where firms are better equipped to hedge against unexpectedly large swings in exchange rates, and that exchange rate stability has been an essential feature of countries with sustained export growth (UNCTAD 1987; UNCTAD 1989, Part One, chapter V).

Increased borrower's risk also affects the lender's risk and, hence, the interest rate, since it increases the probability of involuntary default, thereby tending to push up the interest rate and depress investment further. Moreover, the rate of interest also increases through other factors affecting the lender's risk. Increases in the volatility of interest rates and the prices of financial assets, including equities, lead to greater capital-value uncertainty which, in turn, raises the liquidity preference and lowers the demand for capital-uncertain assets. The result is to shorten the maturities of financial assets and push up interest rates, especially the long-term ones.

Increased competition between assets denominated in the domestic currency and in foreign currency tends to raise the cost of finance also because there is greater risk and uncertainty in developing countries. The fact that most developing countries are economically and politically more unstable than developed countries, together with the weaknesses in their financial and legal systems in ensuring enforcement of contracts, makes financial investment in these countries more hazardous. That is why spreads over LIBOR in international lending are much higher for developing than for developed country borrowers, and why foreign exchange deposits in developing countries have to offer higher rates than those in world markets. In a financially closed economy there are considerable transaction costs in shifting into foreign exchange assets, at least for a large number of small savers, which tend to offset the safety premium on such assets. Financial openness reduces these costs considerably. Consequently, domestic assets need to carry much higher rates of return than external assets to make up for their additional risk.

The effect of high interest rates on the competitiveness of industry in developing countries can be very serious. In these countries the equity base of corporations is usually very weak, leverage high, debt maturities short, and corporate debt contracted at variable rates. The corporate sector borrows heavily not only for fixed investment but also for working capital, and its ratio of debt to operating surplus is thus very high. Higher interest rates can therefore impose a very heavy burden on firms, requiring even greater reliance to be placed on keeping wages low in order to compete in world markets. That is why many governments have maintained preferential lending to export sectors when deregulating interest rates. In Turkey, for example, interest rates on export credits were kept at around 20-25 per cent during the first half of the 1980s when non-preferential lending rates had almost reached three-digit figures. In Korea all preferential lending rates were ostensibly abolished, loan rates unified, and interest rates officially deregulated in the course of the 1980s partly as a result of external pressures, but in practice targeted export industries continued to receive preferential treatment by virtue of access to bank loans which carried below-market interest rates (UNCTAD 1991, box 13).

It is now widely recognized that direct allocation of low-cost credits played a major role in the industrialization of the successful Asian NICs during the 1960s and 1970s (Amsden 1989; Bradford 1986; Cho and Khatkhate 1989; Hanson and Neal 1985; Lee 1992; and Westphal 1990). Indeed, almost all modern examples of industrialization have been accompanied by government intervention in the determination of the cost and availability of finance

in the pursuit of selective industrial policies. Success in overcoming productivity handicaps in international markets has often stemmed not so much from a keeping down wages as from the provision of selective incentives and subsidies. Government intervention in the financial sector is needed to ensure that firms facing what is typically a prolonged learning process are not deterred by a lack of long-term funds at low cost. Thus, in Korea "government intervention was necessary not just to steer credit in the right direction but to underwrite production during the learning process that was far more involved than what is commonly meant by 'infant industry protection.' Subsidized credit meant the difference between establishing new industries or not, rather than the difference between high or low profits" (Amsden and Euh 1990, p. 31). Thus, "extensive intervention by the government with South Korea's financial system can be viewed as an internal capital market and, consequently, it could have led to a more efficient allocation of credit than possible in a free-market financial system" (Lee 1992, p. 187). A principal feature of the external financial strategy of that country was to control external borrowing through official approval and guarantees, and allocate foreign capital via the government-owned Development Bank. Capital account liberalization was placed last on the agenda and foreign pressures were strongly resisted. Even in the late 1980s the government continued to prohibit firms outright from borrowing abroad and placed tight controls on short-run speculative capital inflows. In 1987-1988 it relaxed its controls on capital exports, but reimposed restrictions in 1989 as soon as the trade balance fell short of expectations (Amsden and Euh 1990, pp. 22-23).

Evidence from developed countries also points to the importance of financial control and low cost of finance for competitiveness. A comparison of the cost of capital for corporations in the United States, Japan, Germany and the United Kingdom for the period 1977-1988 indicates that the United States and the United Kingdom had a considerable disadvantage in relation to the other two economies. This has contributed to declining competitiveness of the United States in recent years; lower capital costs and a more predictable supply of finance appear to have enabled Japanese firms to undertake longer-term projects, including investment in research and development, whereas United States firms have been deterred (McCauley and Zimmer 1989; Poterba 1991; Zimmer and McCauley 1991). Historically, financial asset prices and interest rates in Japan and Germany have been less volatile than in the United States, bank deposits more stable, and financial disruptions and bank failures less frequent. It should be noted that for most of the postwar period these two countries, particularly Japan, have been financially much less open than the United States and Britain and much more regulated; in both countries industry has also had much greater integration with banking through financial organizations with characteristics of internal capital markets (Akyüz 1992a).

It should be noted that in recent years, particularly since the 1984 United States-Japan agreement on capital account liberalization, the Japanese financial system has been showing signs of strain in reconciling a policy of cheap finance with financial openness. There have been severe fluctuations in equity prices, interest rates and the exchange rate in recent years, which, as noted above, often posed serious policy dilemmas. With the collapse of equity prices and the rise in interest rates, the dilemma appears to have been resolved in favour of a higher-than-historical cost of finance in Japan, at least for the foreseable future, eliminating (or even reversing) the cost advantage of Japanese firms vis-à-vis American firms (Martin 1992).

V. Conclusions

The focus of attention in developing countries in the design of financial policies should be industrialization and stability. A common feature of all modern examples of industrialization is that all the countries concerned have succeeded in making finance serve industry and trade, not vice versa. This is no less true for external finance.

Complete isolation of the financial system in a developing country from the rest of world is neither feasible nor desirable. Successful export performance requires close interaction of banks at home with international markets in order to provide trade-related credits and facili-

tate international payments. The ability to borrow in international capital markets allows diversification in financing and helps reduce the vulnerability of private and public companies to unexpected changes in financial conditions. Entry of foreign banks into domestic markets can bring greater competition in the provision of trade-related banking services, thereby reducing intermediation margins and the cost of finance. Similarly, foreign investment in capital markets can help corporations to broaden their equity base and reduce their leverage.

However, particular care needs to be given to the design of external financial policies since mistakes in this area tend to be very costly and difficult to reverse. Allowing residents uncontrolled access to international capital markets has proved damaging in many developing countries, and short-term speculative capital flows have proved extremely troublesome even for industrial countries. Most developing countries need to exercise considerable control over external capital flows in order to be able to pursue autonomous interest rate and exchange rate policies. It is usually possible, despite the difficulties involved, to separate trade- and investment-related financial transactions from short-term capital transactions, and to "throw some sand in the wheels" through such means as a financial transaction tax in order to "deter short-term financial round-trip excursions" (Tobin 1978). They also need to control borrowing by residents in international capital markets in order to prevent debt accumulation not matched by greater export capacity. Finally, access of non-residents to domestic capital markets should be restricted since, among other things, close links between the two inherently volatile markets can be very dangerous.

It is important to bear in mind that price stability is vital for a financially open economy, since high inflation and wide interest rate differentials with reserve-currency areas can lead to big arbitrage opportunities and encourage unsustainable capital flows. Similarly, while controls can help prevent spontaneous destabilizing movements in currency and financial markets, they will not succeed in stemming capital flight in the face of economic and political instability. Foreign currency accounts may help to keep dollars at home, but they are poor substitutes for monetary and fiscal discipline.

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